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"Help is coming and it's coming soon". Dr. Anthony Fauci, US infectious disease specialist, November 11, 2020

The Winter of our Discontent – and will it be saved by the Cavalry?

Highlights:

- **Last quarter we spoke about a source of cognitive dissonance as the relentless march upwards of the US stock market seemed at odds with the reality on the ground. This continues, although as we write there has been more of a falter – with rising Covid-19 case numbers, rising hospitalizations, and renewed lockdowns as in the Spring, although there seems evidence that a vaccine is nigh.**
- **Prior to this, markets had calmed, with volatility much subdued, and growth stocks continuing to dominate. The US continued to be the engine of global stock market strength, although China's impressive post-Covid growth trajectory shored up Asia, while Europe and the UK continued to lag as the region's Covid second wave seemed some weeks ahead of the US.**
- **On the high street, meaningful pain is still in evidence. Before the announcement of an extension of the furlough scheme in the UK to March 2021, there had been waves of lay-offs announced, while bankruptcies have been ticking upwards both in Europe and in the US.**
- **Although 3Q GDP showed a sharp recovery in GDP globally following a disastrous 2Q, it is by now obvious that meaningful comparisons to history are not helpful in this respect. As the situation deteriorates around Europe and the US as winter approaches, it now seems that the winter of our discontent is upon us.**
- **Much is riding on the arrival of the "cavalry" in the form of an effective vaccine and markets reacted with euphoria to the announcement by Pfizer and then Moderna in early November that vaccines in development looked to be 90-95% effective. This sparked a "rotation" in the stock market out of the "stay at home" tech winners such as Netflix, Zoom and Peloton, into some of the more overlooked value stocks, and even cruise lines and airlines. This may have been a little premature (especially as there seemed to be less**

efficacy with the Oxford/Astra Zeneca trial and it is now being repeated) but it is probably an indication of how markets will likely react upon each burst of positive vaccine news.

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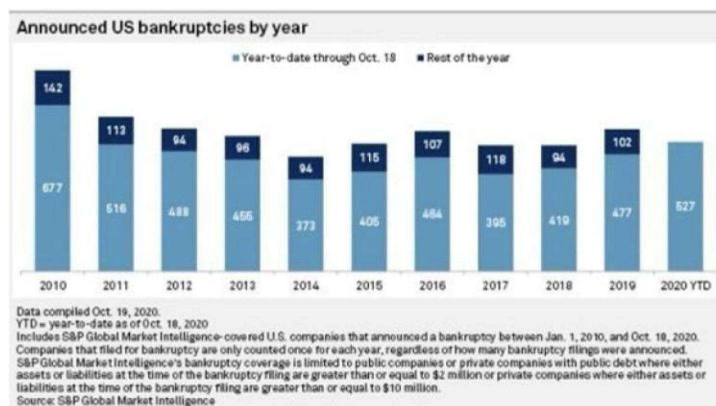
Current Macro Snapshot

Coronavirus, back to square one?
At the date of our last quarterly update the global deaths and case numbers from Covid-19 had risen to 817,000 and 23.8 million, respectively, and the change from then has been stark, as global deaths and cases numbers now near 1.3 million and 52.5 million. While this does reflect vastly increased testing and the pattern globally is similar, there is a laser focus on hospital capacity and avoiding excess pressure on it and action has been swift and pre-emptive across most of continental Europe and the UK. With citizens here back in lockdown, there is a sense of returning to the uncertainty of the summer, perhaps without the shock and fear factor that characterised the early months.

The ability of most professional sectors to muscle through the remote working reality has perhaps deferred a true reckoning of the economic impact of such a widespread contraction in consumer activity. While small businesses and the service sector have already viscerally felt the pain of forced closures and capacity limits before that, the lagged effect of slowing on professional services may only be evident in 2021.

In the US bankruptcies are rising (although not at historic highs), while small businesses there are showing slumping confidence. It is suggested that this data could well be replicated globally, and as we have noted before, it is highly likely that the true extent of corporate distress is not yet known, due to the tendency of lenders to "extend, amend and pretend" and artificially prop up flailing companies during this period of extraordinary stress.



An unsettled US election – but does the market really care?

A tense US election season passed, and as we write has still not been finally resolved due to the failure of Donald Trump to concede to Joe Biden. The split administration (with a Republican controlled Senate) looks set to operate as a lame duck and to see little structural legislative change, and this expectation of "more of the same" cheered markets. The ominous indications that the democratic election process was being challenged did little to shake the market's positive momentum either. It seems that periodically the market does pay attention to exogenous factors, but in recent weeks it was only the Coronavirus and vaccine news that "moved the needle".

We are still talking about the shape of the recovery

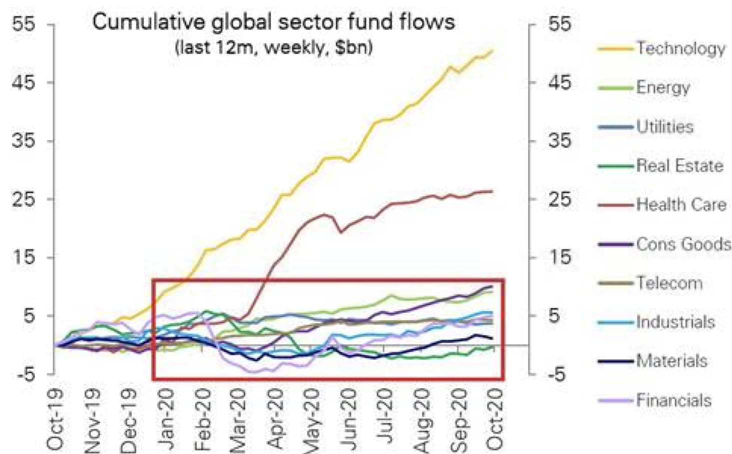
We have continued to look at the current shape of the economic and market recovery, and, as noted previously, the two have long since stopped mapping in terms of their respective shapes. GDP in the US grew at 33.1% in the third quarter, which beat expectations, and was driven by a rise in business and residential investment, as well as strong consumer activity. This cheered markets after the 2Q (when it contracted between -31% to -33%) was the worst quarter in history.

The UK GDP figures released in mid-November showed that UK GDP expanded by 15.5% in the third quarter, the fastest increase on record but slowed significantly in September suggesting that there was likely to be a further dip in the fourth quarter (GDP expanded by just 1.1% in September, which was below expectations, following expanding 9.1% in June, 6.3% in July, and 2.2% in August). It should be recalled that Q2 numbers for GDP were dire in the UK, as it contracted by 20.4%, its most ever. At current levels GDP is still down 9% from February 2020 levels, which is more than twice as large as the cumulative drop in GDP observed in Italy, Germany and France and nearly three times the size of the cumulative drop of 3.5% in the US. The UK media didn't ignore this, noting that the contraction was the worst in 300 years and that with an unemployment of rate of 7.5% the recovery could take upwards of 5 years to take hold.

Source: ONS

Markets stay enamoured with growth and abandon value

As we noted last quarter and are updating now, investor sentiment has been solidly behind healthcare and tech stocks in the US, although since the summer there has been more breadth in evidence, perhaps an early harbinger of the long-expected "rotation" back into value stocks or any stock less exposed to the "stay at home" economy.



Let's try to understand just how stark the divide in value v. growth investing has become. The charts below show the cumulative loss of the value factor since its most recent peak, as well as the relative performance of the value factor compared to other factors used by managers such as growth, quality and momentum.

This historic gap is why certain managers underperformance seems to be persisting far longer than might have been expected based on their history, and why divergences are occurring between more traditional "core" managers and those who have let their style drift towards growth.

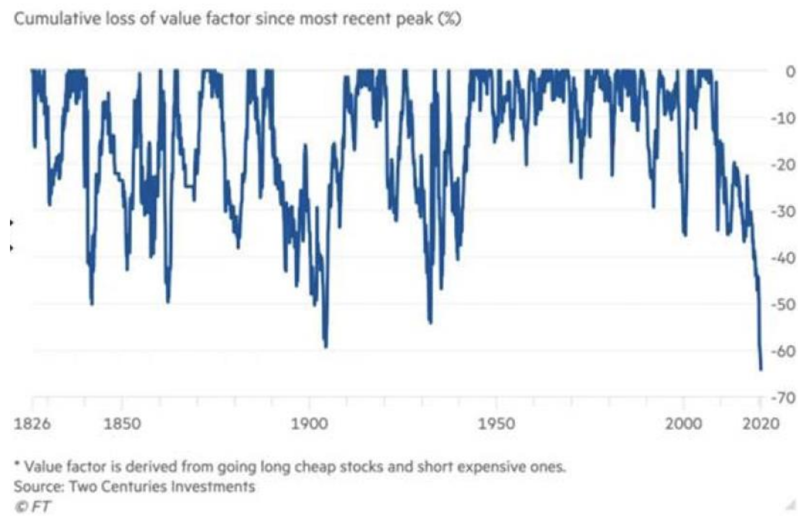
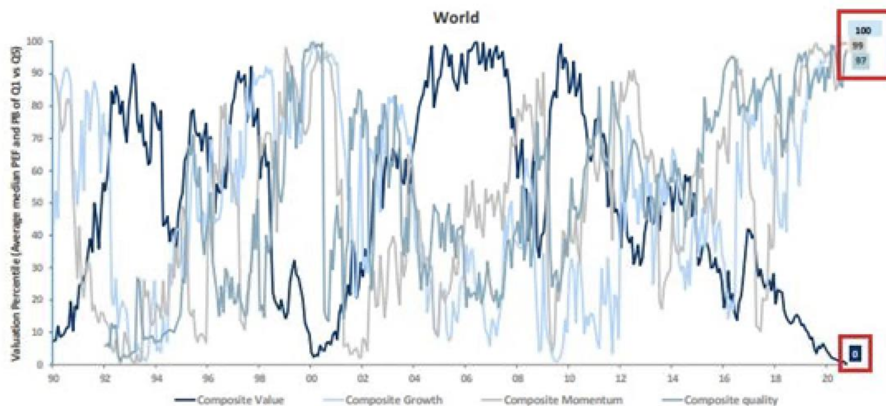


Exhibit 7: Percentile Valuation of Factor in MSCI World since Dec-89



Source: FactSet, Morgan Stanley Research. Pctl % of average median P/FE & P/B of Q1/Q5. The factors are the top versus bottom quintile from MSCI World.

The chart below shows how the percent of stocks beating the S&P over the trailing 12 months is now reaching lows not seen since 2000. It is no secret that active management has struggled v. passive management, particularly as a select few growth stocks have dominated markets. This chart may therefore explain the apparent long term erosion of the ability of managers to add value, but it is also interesting that each historic low point (circled in red below) is followed by an immediate jump in the % of stocks beating the S&P, suggesting that this too is a cyclical phenomenon and may be poised to change. So maybe active managers should be given the benefit of the doubt for now.

Currency movements:
Just as volatility remained subdued across equity markets after the summer, there were only modest movements in currency markets, and Sterling was more or less flat against the USD and has only lost less than 3% year to date. The Euro has maintained its strength against the USD throughout the year.

Individual Asset Class Performance

- Equities
- Fixed income
- Private Assets: Spotlight on Real Estate

Equities: More of the Same

While US markets were under intense pressure in October, the swift recovery in early November erased most of those losses and the S&P is now up over 12% for the year, with the Nasdaq up over 36%. In Europe and the UK, recent strength in early November erased most of the losses in October, but the markets continue to lag US ones – the FTSE 100 is still -16% for the year, while the Stoxx is down -6%. In Asia the markets were strong, led by continued evidence of a strong recovery in China. The Shanghai Composite had a relatively flat few recent months but is up over 11% year to date, while the Hang Seng had a strong month of November is now down only -6.5% year to date.

Against this strong market backdrop gold lost quite a bit of ground, and is now up only 17% for the year (v. 30% at our last quarterly update) while oil remains extremely weak – halthough has regained ground over the past month (up 20% in November) on the back of growing optimism, but is still down -27% for the year.

Fixed Income/Credit: rates stay low, inflation is subdued while high yield acts like equity

The US election outcome promised more of the same in terms of fiscal and monetary policy, although incoming President Biden is less likely to be inclined to strong arm the Fed chairman into a favourable interest rate policy. Nonetheless, rates still look poised to stay lower for longer, and as the next stimulus plan may be limited or constrained, riskier debt (CCC rated) continued to underperform more highly rated (BB), but that is probably due to the fact that BB rated debt (high yield) has more investment grade fallen angels in its mix. High yield did, however, outperform investment grade in recent weeks suggesting that the same exuberance in equity markets has carried over into high yield.

Private Assets: Spotlight on Real Estate

While the Covid-19 crisis has accelerated certain trends in real estate, such as:

- Shift from high street to online retail
- Soaring demand for industrial and logistics properties

Other sectors have seen their trends blown apart, such as:

- High end core office space (urban core)
- Open-plan and hot-desk office spaces
- Core urban developments
- Student housing
- Co-living developments
- Commuter towns
- Hospitality – esp. hotels

As an example, "urban core" is the name given to high end quality (trophy) assets in desirable urban locations such as City of London, New York, San Francisco and Chicago. As office blocks sit empty and tourism and business travel has all but collapsed these properties have seen the fundamental investment thesis "turned on its head", according to Dave Goodson, head of securitised fixed income at Voya Investment Management. The high-end hotel sector has been described as "comatose" and as the chart below shows, there is some concern that distress in this sector will undermine the $4 bn commercial bond sector that supports it. Trophy properties such as the Hilton Times Square have closed and essentially "handed back the keys" to lenders, as the fall-off in revenues has been described as "catastrophic".

The evidence of stress in the lending market to high end hotels is shown in the chart from the Financial Times below. It is clear that other markets could potentially head in the same direction should the precarious "amend, extend, and pretend" phase come to an end.

As we still all work from home, there is clearly a real state of uncertainty surrounding the fate of certain real estate sectors, while others, such as supermarket REITS, may be looking artificially strong – as

essential services during a particularly challenging time. This calls for a long hard look at our current real estate portfolio, not necessarily with a view to making tactical changes, but rather for re-working whatever "worst case" scenario analysis was factored into the business case and resetting expectations accordingly.

Outlook: So where do we go from here?

The US describes its vaccine development program as **Operation Warp Speed**, and this is certainly true for the pace of all change currently. If we look at what he highlighted last quarter – length of Covid disruptions, corporate confidence and US election fallout - certain open items have been resolved – the incumbent lost in the US election and markets barely registered a reaction. As policy looks to be more of the same, markets are focused on Covid and vaccine developments as well as corporate strength, not politics.

We are perhaps moving out of a phase of lockdown politics. While last quarter there was uncertainty about how different nations would respond to their rising cases, it seems that it is now clear that national lockdowns have gained more acceptance politically as a mitigation strategy, even if they are controversial. While we still don't know how long they will continue, we know that intermittent lock-downs can act as a brake on economic activity, but that while they suppress it they do not destroy it. The recent announcement that Chancellor Sunak would extend the furlough payment to UK employees to March 2021 delayed some inevitable pain in the UK employment situation, and maybe, just maybe, the can will be kicked down the road further in order to see an economic uptick.

In the months ahead it will also be interesting to watch for the following:

- **From lockdown politics to vaccine politics** As Pfizer fired the starting gun on a successful vaccine announcement we can expect a flurry of others to follow – and further testing and verification of vaccines developed and already being circulated in China and Russia. The politics of who gets the vaccine and how quickly and whether it will be mandatory can be expected to dominate the first half of the year. It will be interesting to see how this intersects with improved and more accessible testing and how it provides a roadmap for a return to fewer restrictions.

- **The Brexit endgame** As the end of the transition period with the EU nears, negotiations are again down to the wire. As ferry companies expect a surge in demand for freight pre-Brexit and Kent prepares for massive lorry tailbacks, the months to come may well be transformative, although as much of the uncertainty currently exists as an overhang in markets in the UK, it is probably the case that markets will act on positive surprise rather than fall further if no outcome becomes clear.

- **All eyes on the US transition and a reset in foreign relations** As we write President Trump has still not conceded the presidential election and law suits are pending as well as a recount in Georgia. So far all indications are that these suits are without merit and a transition is likely to happen, albeit not in the magnanimous and smooth way that it has in the past. With his hands tied in terms of working with Congress, we can expect a flurry of executive actions at the outset, many overturning those of Trump – in areas of immigration reform, and environmental matters, including in particular the re-joining of the Paris Climate Agreement. All indications are that a Biden administration will be significantly less volatile than what we have seen for the past four years, and this may lead to less news coverage and maybe more normalized foreign relations.

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November 30, 2020