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Keeping you informed matters

Economic review

July 2020

Outlook

As coronavirus lockdowns are lifted, investor optimism for the recovery is being tested as the risks posed by a second wave of infections grow. Geopolitics remains in the spotlight in a US election year and Brexit returns to the headlines for the UK and Europe.

The second quarter continued to test investors despite financial markets staging a much hoped for V-shaped recovery from the lows seen in March. As governments globally felt they had controlled the spread of the coronavirus, lockdown measures imposed to protect the health of populations began to be eased.

But just as economies start to reopen and markets looked ahead to next year, we are reminded of the health risks of easing lockdowns too soon. COVID-19 cases globally have surpassed 14 million, with a surge in infections in several US states that had reopened, Brazil reporting record-breaking new daily cases over the last week and closer to home it appears Leicester is the first UK city to be put under local lockdown. Concerns therefore remain elevated and markets have paused to assess the situation.

Economic and company forecasts are beginning to reflect some of the potential for the recovery to be sustained, but of course, these are heavily caveated with keeping the virus under control. The International Monetary Fund (IMF) who provide a reliable guide to the global outlook, have become increasingly pessimistic on how deep the recession will be and less optimistic on the strength of the recovery into next year. It expects global economic growth to shrink 4.9% to -1.9% this year, recovering -0.4% growth in 2021, substantially lower than the 4.6% global growth forecast pre-COVID-19.

The implications for this of course are that company earnings and profits will be lower, putting wages and jobs at risk. Once unemployment builds, it can be a rolling stone and toxic for economies heavily reliant on the consumer. Governments and central banks will therefore need to keep policy loose and continue to provide support for their economies, which means debt levels will grow further and interest rates and inflation are going to be low, if not negative, for the foreseeable future.

Geopolitics could destabilise the picture further this year with the US elections affecting the biggest market globally. Potential for a Democrat-led House of Representatives and Senate, making them the dominant force in setting US policy, needs to be considered. A Biden government is not seen to be as business friendly as the Republicans under Trump. Brexit negotiations will also create friction in Europe, which for now looks well positioned to take advantage of the global post-COVID recovery.

We had feared from the start of the recovery that the rapid turn in markets meant company valuations had detached from their fundamentals. While we appreciate that some industries will fare better in the health crisis, extrapolating any short-term boost from the virus into the future can be risky. But surely a cure will be found, and the record levels of government stimulus can sustain a supportive environment for risk assets to outperform.

A major factor when assessing the value of a company is therefore understanding its future revenue growth and cash flows. While hazardous for practitioners in the depth of this crisis, none more so than for income investors as a recent report from AJ Bell has shown. The forecast dividend yield of the leading 100 UK blue-chip companies has plummeted to 3.6% versus 4.7% at the start of the year. Of the index constituents 48 have so far either cut, deferred or cancelled pay-outs as a result of the coronavirus pandemic.

The hunt for yield had already pushed those reliant on income into higher risk equity markets, with bond yields trapped at record lows as a result of the additional quantitative easing taking place. As such, investment managers are having to become increasingly imaginative and dynamic in finding alternative sources of income and return, but this can also breed opportunity.

One of the beneficiaries has been environmental, social and governance (ESG) investing. Increasingly recognised as more than just a trend, for ethically minded investors assessing ESG factors this has helped evaluate the genuine risks and opportunities that come with every investment even in this environment. The strong will get stronger.

For now, the key issue for markets remains the spread of the virus. If it is controllable, the V-shaped recovery for economies and markets could continue, but if not, we are aware that much of the good news may already have been accounted for.

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Key facts about the world

United Kingdom

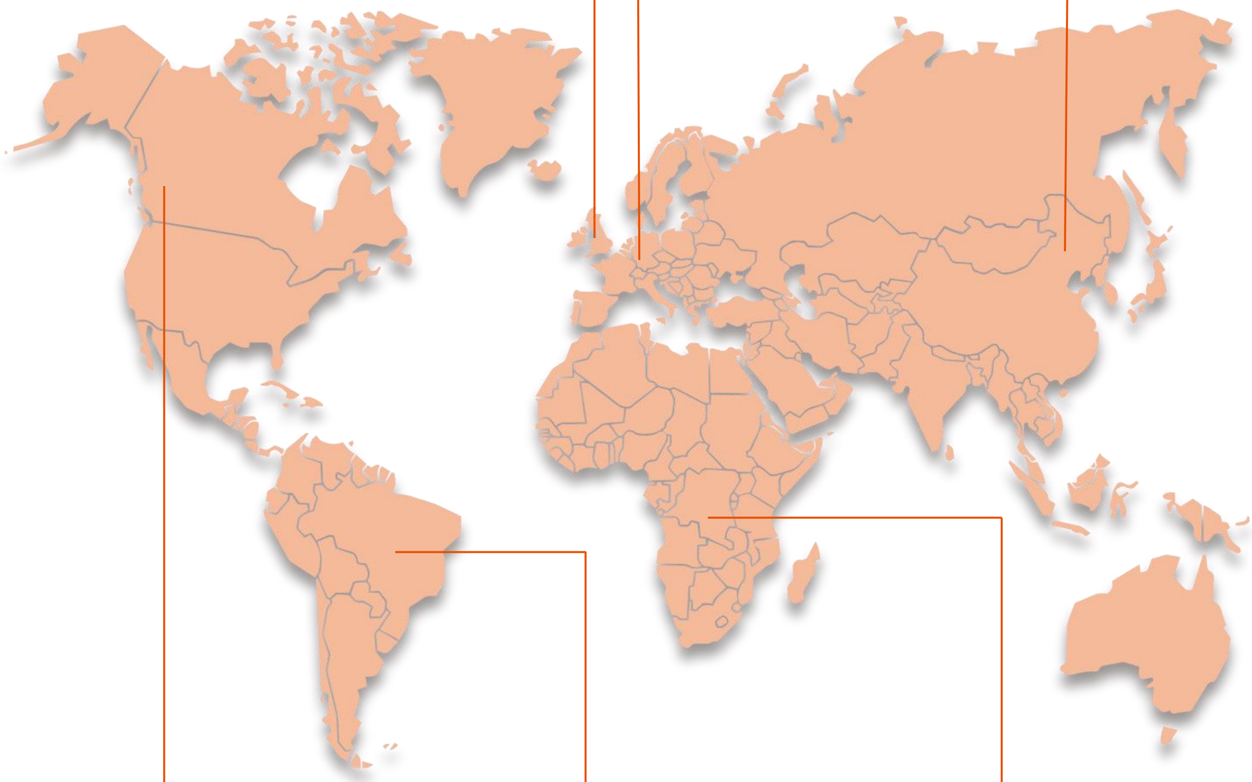
- Brexit negotiations to continue with milestones set for Q3
- Further easing in UK economy with reduced social distancing
- Risk of local lockdowns if second wave not contained

Europe

- Little sign of meaningful second wave following easing of lockdowns
- Fiscal and monetary response has been swift and aggressive, paving way for strong economic and market rebound

Asia

- Early signs second wave seems to have been contained
- Vast population and young workforce, rising wealth, adoption of technology to ensure long term growth post-Covid



North America

- Surge in infection rates could lead to further lockdowns with states battling to reopen
- Re-escalation risk of trade war with China reduced as Trump needs economy at full speed for best chance of winning election

South America

- Fast spreading virus to push region into deepest recession in modern history as commodity prices collapse and value chains disrupted
- Limited fiscal capacity to counter effects of the crisis

Africa

- Economic activity expected to contract by 3.2% this year reflecting weaker external environment and cost of dealing with COVID-19
- The forecast recovery in 2020 is now reliant on coordinated effort by all development partners

Q2 Performance Review

Key facts

- Equity markets stage significant rally from March lows
- Government and central bank policy to keep bond yields, interest rates and inflation lower for longer
- Environment favours higher yielding assets although dividends under pressure
- Optimism and second wave virus fears battle for market dominance

The second quarter has seen many financial markets stage a significant rally from the lows in March, some in excess of 35%. The core US index of the 500 leading companies stands just 6.6% below where it started the year and just 8.4% below all time highs. Asian markets similarly have shown remarkable resilience, with Japanese equities just 4% behind for the year and China ahead 2.3% and setting new highs since 2015.

Accordingly, our core funds in these regions have performed well, with the Natixis Loomis Sayles US Equity and Fidelity Asia funds returning 16.5% and 2% respectively year to date. The JPMorgan Emerging Markets fund has also provided a positive highlight in our strategies, up 2.5% for the year and recovering nearly 27% in Q2. For our more adventurous clients, the heavily tech focused Scottish Mortgage Investment Trust is up a staggering 43% year to date, a theme we are looking to take further advantage of as we move into the “new normal” of industry adjusting to homeworking, ethical practices and social distancing in the year ahead.

Returns have been somewhat more challenging to achieve elsewhere, and we have been disappointed to see our Japanese funds underperforming their targets year to date. However, after regular reviews with the managers, we are pleased to see early signs of a recovery in Q2, which will be monitored closely in the following months.

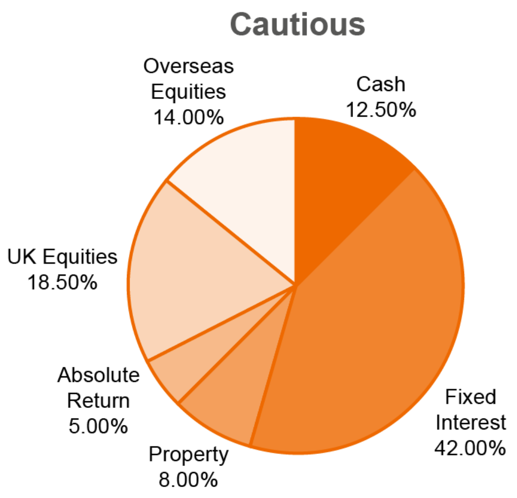
The more cautious elements of the strategies also continue to perform as we’d hoped. These have provided balance for the riskier assets during bouts of volatility, but also contributing positive returns where government support has involved huge bond buying programmes, boosting capital values in the first half of the year.

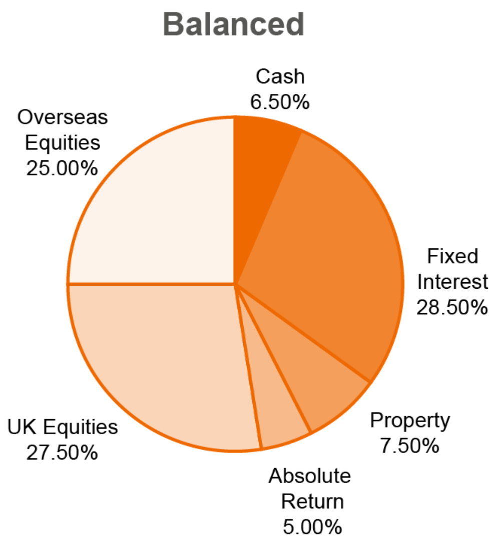
This depresses the yields of course and combined with low interest rates and low inflation, this is favouring higher yielding assets such as equities, property and infrastructure over government bonds and cash. Given the strain on cash flow and dividend payments currently, we have already begun the process of identifying new and alternative investment strategies to replace lost income without adding risk.

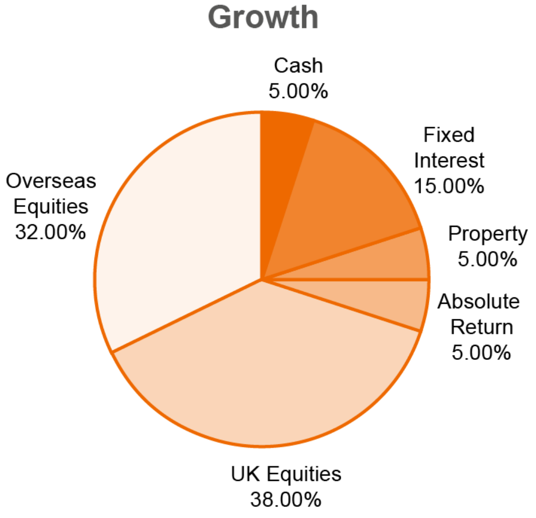
SECTOR	Q2 2020	2019	2018	2017	2016	2015	5 years (annualised)
IA OE UK Index Linked Gilts	7.7%	5.9%	-0.5%	2.2%	25.1%	-1.3%	5.9%
IA OE £ Corporate Bond	7.4%	9.5%	-2.2%	5.2%	9.7%	0.2%	4.4%
IA OE Property	-1.7%	-0.8%	2.9%	7.6%	-2.0%	7.6%	3.0%
IA OE UK Equity Income	11.0%	20.1%	-10.5%	11.5%	9.1%	6.6%	6.9%
IA OE UK Smaller Companies	19.8%	25.4%	-11.8%	27.1%	8.5%	14.9%	11.9%
IA OE North America	20.7%	24.6%	-1.2%	10.5%	30.1%	4.5%	13.1%
IA OE Europe Excluding UK	20.8%	20.4%	-12.2%	17.5%	17.1%	9.4%	9.7%
IA OE Japan	16.2%	17.1%	-11.3%	17.8%	23.5%	16.2%	11.9%
IA OE Asia Pacific Excluding Japan	20.3%	15.8%	-9.8%	25.3%	26.0%	-2.8%	9.9%
IA OE Global Emerging Markets	20.1%	15.7%	-11.5%	24.5%	31.6%	-9.2%	8.8%

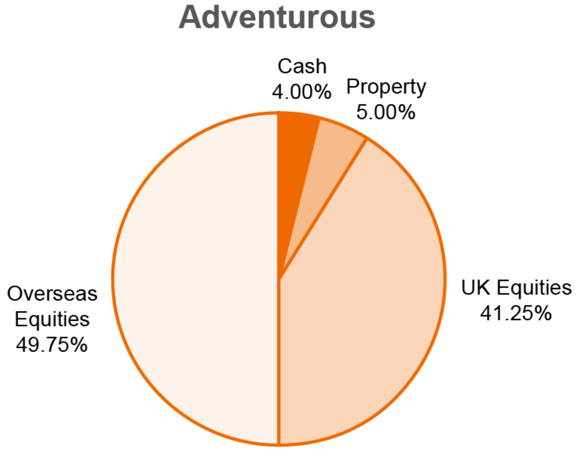
Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

The positioning of our strategies

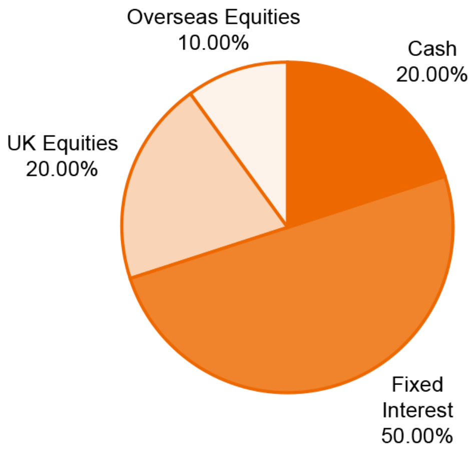




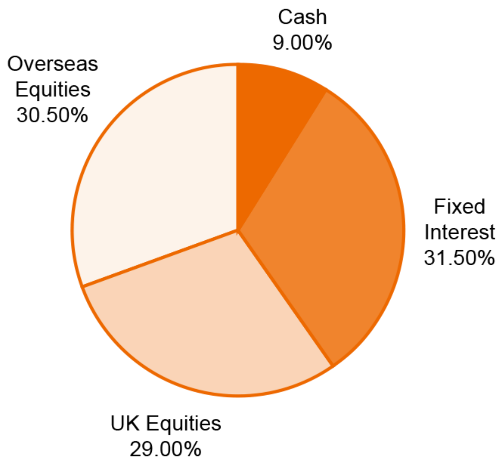




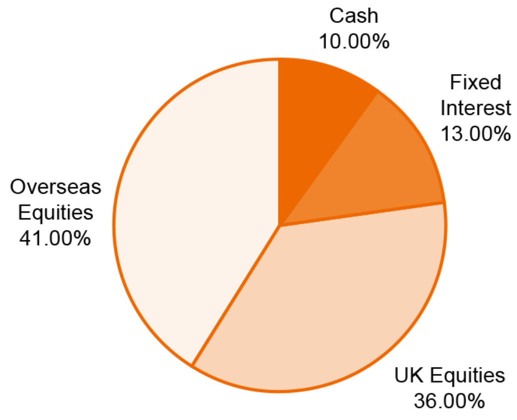
Ethical Conservative



Ethical Balanced



Ethical High Growth



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