Psigma
Investment Management

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Brief View from Psigma

Going Backwards (At Least for Now)

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After a broadly non-stop recovery for global asset markets over the last seven months, we have seen a resumption of volatility over the last few weeks. We thought it would be useful to update you briefly on why this renewed pressure has been put upon asset prices and what the next few months could bring for investors, as we end what has been the most turbulent year for the global economy in many decades.

In very simple terms, financial markets are reflecting what we are seeing in the global economy. Markets started to recover in March of this year, when central banks and governments around the world opted to pump huge amounts of monetary and fiscal stimuli into their respective nations. This brought the promise of a stabilisation and subsequent improvement in economic growth, which triggered a reflexive response in asset markets. One could make a cogent argument that some investments had risen too far, too quickly, and outpaced the economic reality, but the basic premise for asset markets' improvement was that governments and central banks had done enough, and that lockdowns would eventually be reversed and the world would heal.

Financial markets are now falling in fears of a further slump in economic activity, or at least a pause in the recovery, in the coming months. This is particularly the case in the UK and Europe, where regional equity markets have given back any ground that they had won over the last six months. It is worth noting that these markets have considerably lagged behind other parts of the world throughout this year. News that most of Western Europe is now going to be back under severe restrictions is not good for asset markets and will be a negative impulse on global economic growth.

It seems likely that the fresh range of economic and social restrictions will be enough to send growth rates in Europe and the UK negative in the coming months, and this is supported by evidence from deteriorating indices on consumer confidence. News around the world is better, with Asia broadly still recovering well and the US enjoying a slowing but gradual economic improvement, but all global growth expectations need to be lowered for Q4 2020 and, in all likelihood, Q1 2021.

The likely pause in the economic recovery will have an impact on global corporate profits, which is another reason why equity markets have stuttered in the last few weeks. Notably this volatility has arisen at a time when the world's biggest companies are reporting to investors how they performed in the three-month period between July and the end of September. The news remains better than investors had been guided to expect (this is always the case): profits are admittedly still significantly lower than a year ago, but better than we had been encouraged to expect by companies themselves. However, the interesting pattern to note is that companies are beating these low expectations but have not been rewarded for it, with overall markets falling, implying that some asset markets had already been "priced for perfection". Clearly, one of the major factors that we must assess as we move in to a new (and hopefully easier) year in 2021, is how corporate earnings will fare. This is nearly impossible to predict at this time, although it is clear from most analysts and commentators that great things are expected to justify the lofty valuations we are seeing in some markets, most notably in the dominant US equity market. Such has been the pace of the recovery in companies' share prices across the Atlantic that valuations have reached levels only once surpassed in history: at the very peak of the tech bubble in March 2000. Until we see progress on the medical and economic fronts, it would be sensible to temper some of the obvious enthusiasm that has been on show in markets over the last few months.

Any view on the economic recovery and the strength of corporate profits over the next few years might be easier to answer this week, as we find out the results of the US election. Most commentators are expecting a "Blue Wave", with the Democrats taking control of the White House, Congress and the House of Representatives. Before the tragic events of the COVID-19 crisis became apparent in 2020, with the perception that the Trump administration has handled the crisis badly, we would have ascribed a very low probability to a "Blue Wave" scenario. Admittedly, we are now not sure. In truth, we would view any outcome as possible, with the House of Representatives staying in Democratic control seemingly the only certainty. Despite the polls clearly pointing in favour of a Biden presidency, we would view the election result as being much closer to call and the control of Congress being a "coin toss" scenario.

We would be totally unsurprised to find the markets surprised by the eventual outcomes of the election. We use the term "eventual" carefully, as there is the real chance that legal challenges may appear over any result. This fear of a contested election has contributed towards the recent volatility, as has the resumption of a closing gap in polling numbers. Given the uncertainty over the election results, we are not positioning portfolios for short term post-election market moves, (although we have the option of doing so), but rather the medium-term trends that we expect, including a large stimulus focused on infrastructure and policies on the healthcare sector.

In conclusion, there are three key reasons why markets have stumbled and fallen over the last few weeks. Firstly, markets had enjoyed a major recovery over recent months and had arguably moved "too far, too quickly"; some profit-taking across markets seemed likely and our portfolios have reflected the high chance of this taking place. The good news for our portfolios is that (so far) we have not seen any significant price pressures across credit markets (although this is possible). In addition, the economic news has clearly deteriorated in Western Europe and in an interconnected global economy; this will be a suppressant on global growth rates. This pause in the economic recovery will likely lead to profits expectations for global companies being reduced, at a time when the valuations of many companies are already expensive. Finally, in a year in which we're sure we can all agree that we have had enough "drama", the US election promises to be a nerve-jangling scene that markets will have to deal with before we can hopefully have some calm to end the first year of a decade that we have long promised would be the "Turbulent Twenties". Our portfolios reflect the recent return of volatility and we are hopeful that the market fluctuations will afford us the opportunity to tactically add to investments once again.

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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