Psigma
Investment Management

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View from Psigma
VALUATION COMMENTARY

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Following the rollercoaster ride of the first six months of this year, including the most extreme decline and subsequent fastest recovery on record for global equity markets, at the halfway stage of this "memorable" year we had all hoped for a calmer third quarter of 2020. The continuation of the gains for most global stock markets and the impressive march higher of global credit prices afforded investors a period of relative relaxation, in a year where such a sensation has been hard to find. Global asset markets' performance did not necessarily reflect the improving but still frail global economy, the precarious personal financial situations of many of the world's citizens, the unprecedented creation of debt to pay for our governments' actions or the challenging medical situation.

Many of our clients have asked whether the disconnect between the economy and asset markets can be sustained as we end this turbulent year and head into the uncertainty of 2021.

The global economy recovers

Before we can answer that important question, we must assess where we are with regard to the global economy's recovery from the nadir of this recession in the second quarter of 2020. The good news is that there has obviously been a major improvement in economic conditions, albeit from the depths of the worst economic decline since the end of World War 2. As various individual economies reopened around the world, we expected that we would see a powerful initial recovery and fortunately that is what we have experienced. However, the initial "V shaped" bounce has stalled in recent weeks, as governments have considered it necessary to maintain strict restrictions on economic activity and, in some cases, have decreed it vital once again to start closing parts of their respective economies.

At a headline level, global economic growth has plateaued at around 85-90% of pre-crisis output, although there are big differences between leading and lagging countries, winning and losing sectors and those who have been protected and impacted across society.

Regional winners and losers

The countries that have led the way in reopening have been those that have dealt with COVID-19 most effectively, particularly China and other East Asian countries. Those that have seen the most brittle economic recoveries so far have been in Europe and certain Emerging Markets, where, for a variety of reasons, management of the economic and medical crises has been relatively inefficient. The UK has sadly been a clear example of a relative loser and the recent actions taken by the UK government seem set to impose further economic pain, which the government has viewed as necessary in dealing with the pandemic. The US has been both enigmatic and disjointed in its approach to assuaging the worst effects of COVID-19, but news appears to be better from the world's biggest economy and their stimulus efforts have ensured an impressive economic recovery so far.

The question of "what next?" is harder to answer. Much will depend on the discovery and distribution of vaccines; the appetite for the general public to take any vaccine; how governments decide to deal with the ongoing medical emergency; and how large any further stimulus efforts of governments and central banks will be. To be completely honest, we simply cannot say with any certainty how quickly the ceded economic ground will be won back, with so many factors unknowable at this time. Our central view remains that there will be a "bumpy" and "below par" economic recovery from now on, following the strong snapback economic surge seen in recent months, with pre-crisis levels of growth only likely to be achieved as we head in to 2022.

The "K Shaped" Recovery

As well as seeing notable differences between various regions and countries as the global economy has started to heal over the last six months, we have also seen a wide divergence at a "micro" level. Indeed, the difference between the fortunes of those sectors that have been considered vital by governments, such as online retailing and big supermarkets, versus those that have seen activity heavily restricted, such as travel and hospitality companies, has been vast. This has led to a "K shaped" recovery where a large cohort of businesses, particularly in the technology sector, have been "pandemic beneficiaries" (the upward arm of the K) and others have seen their destinies destroyed (the lower arm of the K). This has been clearly reflected in the divergent fortunes of various sectors in global equity markets, with some sectors up very positively this year, whilst others have suffered significant falls. For the global economy to return to previous levels of broad output, we will need to see the economic outlook of the sectors that have so far been sacrificed start to brighten.

With many facets of our social and business lives still impaired, it is hard to make such a prediction in the near term. Therefore, we continue to view a full economic recovery as being unlikely in the short term.

The disconnect between markets and economies

Investors have seen the continued stress within the economy and have fairly questioned why asset markets, with some exceptions such as totally unloved UK equities, have enjoyed such a remarkable transformation since the misery of February and March. There are three main factors behind the markets' recovery. Firstly, there is the fact that the economy has partially recovered, as we have described already, and that asset prices anticipated the economic revival. Next, we must also recognise that, due to the panic across financial markets, many asset prices became divorced from their long-term fundamentals in the early months of this year, affording nimble investors an opportunity to buy certain investments at distressed prices. However, in common with the consistent market behaviour of the last decade, the primary driver of markets over the last six months has been the helping hands of central bankers. We have witnessed a gargantuan effort this year from the major global central banks, who have effectively printed vast sums of money to bail out cash-strapped governments, in order to help them fund their various economic schemes, and to intervene directly in financial markets. In addition, all major developed countries now have interest rates anchored at zero to encourage investors to move money from cash and out of government bonds and into riskier financial assets, which has undoubtedly been a major spur and support for asset markets.

Even though we are of the view that these actions will ultimately lead to a rise in inflation rates, we do not expect major central banks to be in any hurry to put up interest rates in the coming years. Indeed, it took the US Federal Reserve seven years before they dared to increase interest rates after the financial crisis of 2008 and we would be surprised if they moved more quickly in this current situation.

Markets can remain expensive

Due to our forecasts on interest rates and our expectation that governments and central banks will have to stimulate more rather than less in the future, the prevailing market dynamics are unlikely to change in the immediate future. Certainly, we would be unsurprised to see further volatility, particularly with the toxic US Presidential Election taking place imminently, as well as the seemingly never-ending Brexit negotiations closer to home, but it is hard to forecast another precarious decline in equity markets and credit instruments when central bankers have nailed their colours to their masts so firmly. They have, in effect, tried to put a floor under asset prices. In the long run, the greatest risk to all asset markets and the global economy is that there is a systemwide loss of faith in these "masters of the financial universe", but that is probably a story for another day. This does not mean that we should just run out and buy any asset, irrespective of valuation. On the contrary, we continue to be very selective and focused on those assets that we believe offer the best potential for growth, even though we are well-balanced across all our investment strategies.

Current investment strategy

In simple terms, there are three key pillars underpinning our investment strategies. The first aim is to ensure that the overall balance of our portfolios reflects the uncertain economic situation ahead. We are comfortable that our diversified investment approach will help us to achieve our clients' aims in the future. We also need to ensure that we have full confidence in each of the investments that currently make up our clients' investment portfolios; the constant and consistent interaction with the external managers who manage various parts of our strategies has ensured that we have vital predictability over the outcomes of each investment in various scenarios. Finally, we continue to stand by our mantra of "volatility is an investor's friend, not their enemy": so far this year we have been able to identify specific opportunities in a range of different investments to take advantage of the rises and falls of individual assets in the wider market volatility.

It remains very obvious, despite the broadly positive views of most market commentators and the growing complacency evident across financial markets, that these key policies will serve us well as we continue through this age of uncertainty and head deeper into the decade that we some time ago entitled the "Turbulent Twenties".

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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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