

DFM CIM GLOBAL INCOME OPPORTUNITIES PORTFOLIO -  
3RD QUARTER 2020 REVIEW

OCTOBER 2020

### Introduction and Market Overview

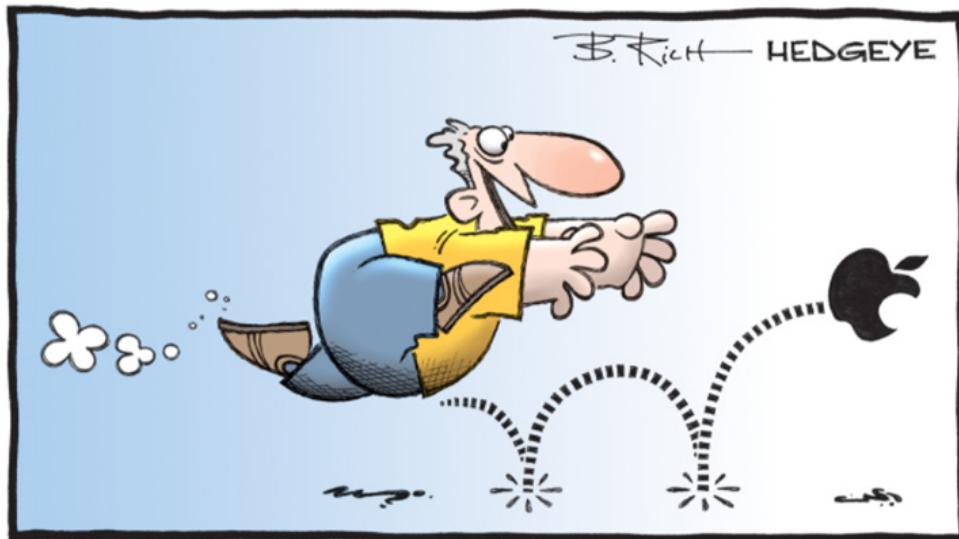
2020 continues to surprise. A pandemic, the shutdown of the global economy, the deepest recession since the 1930s, a global equity market collapse and latterly record highs for the U.S. tech heavy equity market. The upcoming U.S. election is shaping up as a tight contest, with the potential for more surprises and market volatility. Our market update runs the risk of being out of date pretty quickly as European COVID infection rates are on the climb once more and by the time you read this, the UK could well be closer to extended lockdowns.



Currently we are in the early recovery phase of the cycle following the COVID-19 recession. This implies an extended period of low-inflation and low-interest-rate growth - an environment that normally favours equities over bonds. But after such a rapid rebound, the equity market has softened a touch, especially in the value orientated UK market, with its high exposure to energy and financials. Technology stock valuations are elevated, and the U.S. presidential elections create uncertainty around tax changes, government regulations and the re-escalation of China/U.S. trade tensions. Beyond this, consideration must be given to a possible rotation away from technology/growth leadership toward cyclical/value stocks. This also implies a rotation toward non-U.S. stocks with Europe and emerging markets the main beneficiaries. We will return to the 4th quarter outlook at the end of this investment summary, but for now, we will review what has driven markets over the third quarter.

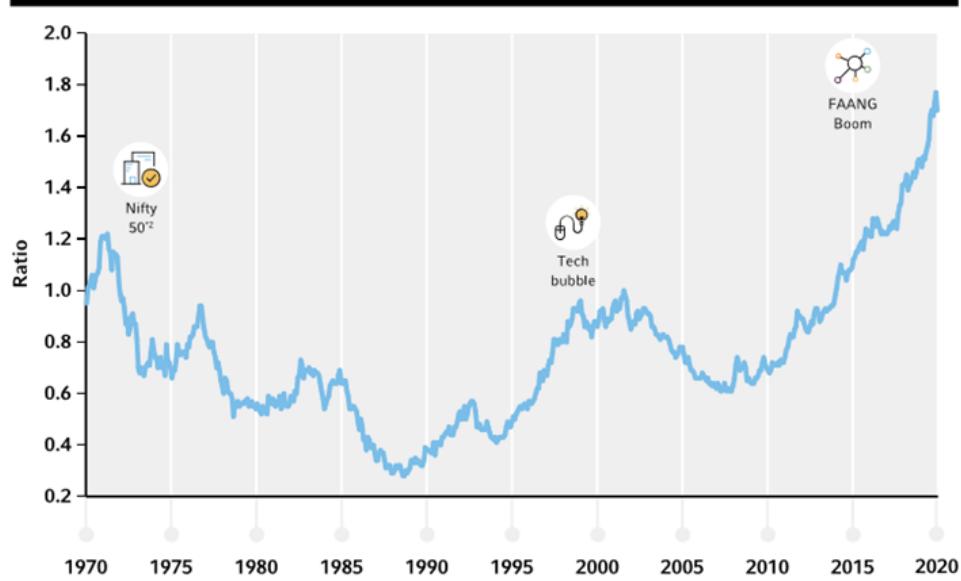
### What happened in the 3rd Quarter 2020?

In summary, long term market trends continued through much of the summer. Tech heavy US stock markets outperformed non-US stock markets and growth outperformed value stocks. Private investors in the US, known as "Robin Hood" investors due to them trading via a platform of the same name, chased the big tech names higher and higher in a gambling mentality as many of the US sporting events over the summer were cancelled due to COVID-19. As a result, ex gamblers became traders and developed a new past-time in stock market investing. Only at the end of the summer were the valuations starting to come under scrutiny.



The upward trend in US equities, growth stocks, and to some extent the US Dollar, are related and started around the time of the 2008 financial crisis. The U.S. market is overweight the technology and healthcare stocks that dominate the growth factor while the rest of the developed world is overweight the financial and cyclical stocks that populate the value factor. The U.S. dollar benefits from U.S. stock market inflows and the positive interest differential when the U.S. economy is performing well.

#### U.S. market relative to Developed Markets ex-U.S.<sup>2</sup>



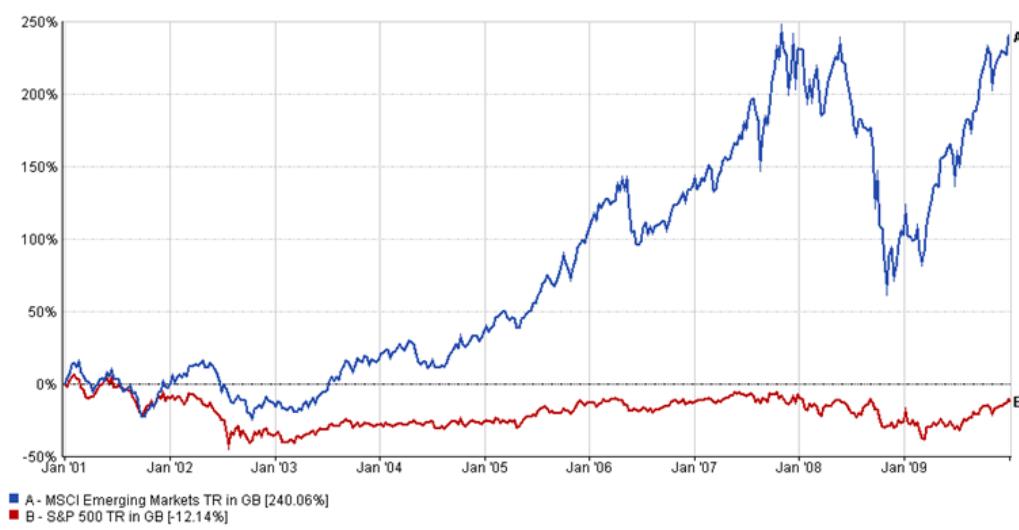
Sources: Refinitiv Datastream, MSCI. Last observation: 17 September 2020. Ratio based on the MSCI USA Index and MSCI World ex USA Index over the time period. Indexes are unmanaged and cannot be invested in directly. Index returns represent past performance and do not guarantee future results.

The surprise here has been U.S. and growth stock outperformance during the rebound from the coronavirus bear market. Cyclical and value stocks - and by association, non-U.S. stock indices - usually perform well during the initial recovery phase from a recession and bear market. But not this time. The reason has been the strong performance of the technology stocks, the so-called FAANGs - Facebook, Apple, Amazon, Netflix and Google. These stocks, plus Microsoft, comprise 25% of the market capitalisation of the S&P 500 as of 16 September, and they account for all the year-to-date gains in the index. Excluding these stocks, the S&P 500 would have declined by around 4% for the period.

Technology stocks received two benefits from the lockdowns. The first was from the decline in government bond yields. Investors typically regard technology stocks as long duration as they are expected to grow their earnings over the longer term. The decline in bond yields made the present value of those future earnings more valuable. The second benefit was from the boost to current earnings from the lockdown as consumers went online for purchases, made more use of video call technologies and watched streaming services.

We therefore are watching this area of the market closely. If lockdowns return and central banks keep yields zero bound for an extended period, with no meaningful increase in inflation, this dynamic will probably drive growth stocks even higher through the rest of 2020. If, however, the winter lockdowns do not come, or are relatively well executed and short lived, global bond yields could start to rise and the near-term boost to technology stock earnings from lockdowns will have peaked. This should allow the normal recovery dynamics to resume, with investors rotating toward relatively cheaper value and non-U.S. stocks that will benefit from the return to more normal economic activity. It is worth remembering the significant outperformance of Emerging Markets versus US Equity throughout the 2000's and there is a distinct possibility that a market shift could emerge in 2021.

## 2000's:



Brexit uncertainty dominates the UK outlook. There is a year-end deadline for a European Union/UK trade deal, but negotiations are at a stalemate. The UK has the weaker position, which is why it is adopting an aggressive negotiating strategy. A hard Brexit on World Trade Organisation terms is likely to have around three times the impact on the UK economy compared to Europe.

The assumption is that a deal will be reached on at least a bare bones free trade agreement, but the risk of a hard exit is uncomfortably high. The Bank of England has started to examine how a negative base rate could be implemented. Negative rates are unlikely, but the Bank of England is flagging negative rates as a contingency for a hard-Brexit scenario.

Brexit uncertainty has been reflected in the FTSE 100 Index, which as of 16 September has been the worst performer of the major developed stock indices this year.

Over the summer we have increased our exposure to Asian equities, and, to a lesser extent, Japan. The Japanese economy continues to lag the recovery of other major regions, with the services sector being particularly disappointing. Prime Minister Shinzo Abe's successor, Yoshihide Suga, should see the continuation of Abenomics, with a focus on policy accommodation to try to achieve 2% inflation. As cabinet secretary, Suga was instrumental in implementing elements of Abenomics. Suga has indicated that he will pursue further fiscal support before year-end in the form of payments to small and medium enterprises and households.

The Chinese economy has seen significant improvement since the COVID-19 crisis, with many indicators now pointing to growth over the year. The consumer and the services sector have started to catch up to the manufacturing sector. Fiscal policy is set to remain very supportive through the rest of the year and we expect that credit creation will be solid.

U.S./China tensions have escalated with U.S. restrictions on Chinese companies including Huawei and TikTok. Nevertheless, we think the phase one trade deal will remain intact through the U.S. election and have been encouraged by multiple reports of increased Chinese purchases of U.S. agricultural and energy goods. We see better value in Asian technology than their US counterparts and this valuation margin of safety could prove important later in the year. Having said that, we are still comfortable to hold US tech, but we have started to overweight some key "stay at home" themes once more as COVID infection rates once again march higher.

## Looking Forwards

The 23rd September marked the six-month anniversary of the equity market bottom and the beginning of our changed way of lives. Lockdown began in earnest in the third week of March and, sadly, governments in Europe are once again tentatively re-introducing more restrictions on social activity and mobility. The headline number of reported new infections is rising again across Europe and even in the US, which was seeing reduced infection rates. Of course, things are different now than they were in March. There is more testing and more testing detects more cases. So far, hospitalisation rates have been modest, but it would be dangerous to be complacent about that, given the lags involved and the potential for the current surge to impact on vulnerable people. Healthcare is better prepared, there is more capacity and a broader range of treatments. However, as many people have repeatedly said during the last six months, a second wave is one of the key threats to the economic recovery. There are also doubts about the ability of governments to keep on spending to counter the potential downside risks.

As announced by Jerome Powell, the U.S. Fed's move to target average inflation is a significant shift in policy. We believe it should lengthen the expansion and delay the day of reckoning for equity markets from the effect of higher interest rates. The Fed's preferred measure of inflation has averaged 1.7% over the past five years and 1.6% over the past decade. This gives the Fed plenty of room to leave the Fed funds rate unchanged after inflation starts to pick up. Other central banks are undertaking similar reviews of their respective policy operations and we expect they are likely to reach similar conclusions.

The other important policy shift will be how quickly governments try to repay the debt arising from the support measures for the pandemic lockdown. Government debt levels for developed economies are likely to increase by around 15% of gross domestic product (GDP) on average. There is speculation that tax hikes will be on the way once COVID-19 has passed. It must certainly be a temptation to them, although fiscal austerity is not a winning electoral strategy and the current ultra-low borrowing cost makes high debt levels more sustainable. The test for governments will come only after bond yields rise meaningfully and capital markets are driven by concerns about sustaining the higher debt levels. The bottom line in our view is that fiscal austerity and tighter monetary policy are still some time away.



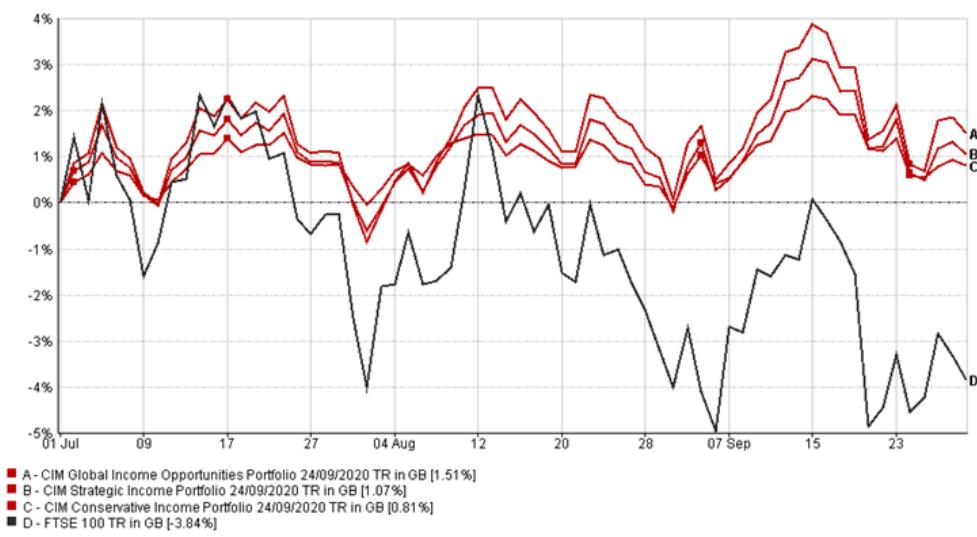
It is a well recited statement that markets like to climb a wall of worry, and there is certainly much to occupy us over the 4th quarter. Infection rates are picking up and the advent of the northern winter could trigger a more meaningful second wave. Offsetting this, death rates have remained low in most countries despite the rise in infections, and vaccine development news has been promising.

U.S. election odds are tightening and it certainly does not help that Trump has now confirmed he tested positive for COVID. The re-election of U.S. President Donald Trump would likely benefit U.S. stocks (tax hikes averted, more protectionism) but a victory by Democratic presidential candidate Joe Biden would benefit non-U.S. shares (more harmonious foreign and trade relations). Added to this, the negotiations in Congress over further U.S. fiscal support have become deadlocked. This would result in a hit to consumer income equal to around 4% of GDP if an agreement is not reached. A Biden victory with Democrats sweeping both chambers of Congress would likely generate the most short-term volatility as investors would need to re-price their scenarios around tax policy. If Trump loses and then initiates a contested election result, this will really destabilise markets. Any significant dislocations in markets around the election should present us with a further buying opportunity.

The last six months have seen an amazing divergence in returns from financial markets. They have also seen us forego travel and eating out, instead favouring home improvements and online retail. Efforts to control the virus and then beat it will go on for some time to come and at times this will weigh on the investment outlook. We will continue to keep a close eye on this, avoid unnecessary investment risks and focus on the sensible areas of the market where we feel the returns are worth the risk and avoid the areas where the odds are not in our favour.

### Portfolio Changes Over the Quarter

The third quarter of 2020 was a more sedate affair compared to the rollercoaster market ride from January to June.



The portfolio fared well in the early summer months and other than a risk aligning rebalance, the portfolio did not require alteration. It was not until the September that we needed to make changes.

A period of market volatility at the end of September then gave us the chance to pick up some favoured assets at discounted prices by slightly reducing bond exposure at low yields and physical gold after a strong run (conscious that gold does not yield an income for our investors). We have used the proceeds to introduce a new holding into the portfolio: **VanEck Gaming & eSports ETF**. The VanEck fund aims to benefit from the strong global trend towards interactive games as a form of entertainment, and this trend accelerated earlier in the year with much of the world in some form of lockdown. With lockdown potentially returning, we felt it a good time to purchase a holding. We also added some assets that would benefit from the slight creep up in inflation – namely **L&G Global Real Estate Dividend Index**. Historically, commercial real estate has outpaced inflation and served as an effective inflation hedge in both high- and low-interest rate environments. In fact, since the National Council of Real Estate Investment Fiduciaries (NCREIF) began tracking private commercial real estate returns in 1978, the NCREIF Property Index (NPI) has exceeded inflation in 32 of 38 years.

In summary, over the quarter we have been able to use some of our lower beta funds to add to equity markets at attractive long term levels and we remain vigilant for any market opportunities that may present themselves before the year end – most likely around COVID, Brexit or the US elections.