Introduction and Market Overview

US Elections, COVID-19, Brexit!

All eyes turned to the US in the 4th quarter to see if President Trump could see off Joe Biden's challenge. Although the method of counting postal votes after polling stations gave us some excitement, ultimately Trump was beaten. We expect him to stand aside and for Joe Biden to be sworn in on the 20th January as President Trump's legal effort to overturn the US election result failed. Joe Biden's campaign and nominations for key posts give us a clear idea of the direction he expects to take. One appointment worth highlighting is Biden's nomination for Treasury Secretary, former chair of the Federal Reserve (FED) Janet Yellen. Yellen will no doubt want to give the FED as many tools as possible, enabling it to provide continued support to the US economy as it recovers from the pandemic. Some of Biden's early initiatives will likely include re-joining the World Health Organisation and the Paris Accord on climate change, as well as increased spending on environmental projects. Should the Democrats fail to gain control of the Senate, Biden's spending plans and proposed tax rises may be diluted. However, a more measured approach to diplomacy should still be welcomed by markets that dislike uncertainty.

COVID-19 once again gained momentum towards the end of the year, although the more vulnerable members of society and health workers had already started receiving vaccinations. However, manufacturing and distribution of the vaccines at scale will take some time, and it may not be before mid-2021 when other vaccines become widely available, to help ease supply. This is more likely the case now that second doses of the Pfizer vaccine have been put back to a 12 week wait to ensure that more people can be given the first dose, which apparently has an efficacy rate of 70% and should reduce symptoms if you were unlucky enough to catch COVID after the first vaccination. There is some much-needed light at the end of the tunnel, and in the meantime, we continue to watch the virus wax and wane and measures to counter the pandemic may be in place in one form or another for most of the year. As a result, it is still too early to be tightening financial conditions, and a continuation of the coordinated support, from both fiscal and monetary authorities, is still needed to prevent long-lasting economic damage.

The main fillip to UK markets in the 4th quarter was the final agreement, albeit at the very last minute, of a trade deal with Europe. The outcome was admirable under the circumstances, as negotiations were conducted during a pandemic, to a tight timetable and with, at times, what seemed to be irreconcilable differences. The deal is broadly in line with precedent but, crucially, by providing for zero tariffs and zero quotas, goes further than other free trade agreements. The fact that the two sides reached an agreement provides a basis for more positive future cooperation than a possibly acrimonious no-deal outcome.

There is little doubt that a deal should be good news for the UK economy. It brings long-waited clarity for business and is a better outcome for the economy than the alternative of operating under the rules of the World Trade Organisation. Trade tariffs and quotas would have added immediate and unanticipated additional costs to trade. Without a deal, Sterling would have almost certainly have fallen and inflation risen. As it turned out, Sterling rallied into the end of the year and the chairman of Tesco, John Allan, said that the effect of the deal would, "hardly be felt in terms of the prices that consumers are paying".

The consensus view was that the failure to reach agreement would have significantly dented the expected rebound in growth this year. A 'no deal' forecast for 2021 UK GDP was 1.3% lower than the current 4.4% forecast from Deloittes predicated on a deal. A deal substantially reduces Brexit-related uncertainties which have weighed on business investment and risk appetite since 2016. The deal may also offer some support to consumer sentiment too. This was certainly the case when a deal started to look more likely as we moved through the fourth quarter and the UK market drove portfolio returns higher in October, whilst investors in US equities worried about the election. It was a very strong rally, albeit from a low base, and it was good to see a "Santa" rally in one of the hardest hit areas of the markets in 2020.

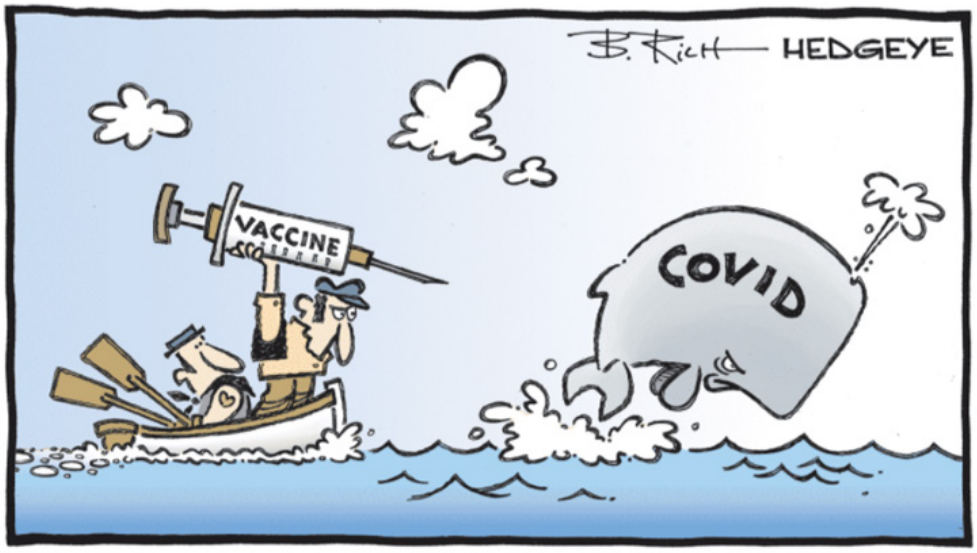
Whilst the Brexit deal helps the immediate economic outlook, it marks a step change towards a more distant, complex economic relationship with the EU. As Professor Anand Menon of King's College put it, "On the spectrum of hard to soft Brexit, this agreement is located very much at the former end". Leaving the Single Market and Customs Union and ending free movement introduces new frictions and costs in economic relations with the EU.

This has been inevitable since the Conservative victory in the 2019 General Election and is not news, but it is highly material for long-term growth. Extra paperwork and bureaucracy will mean more costs. HMRC, for instance, estimates that 215m new customs declarations will be required every year at an annual cost of £7bn. Lower migration from the EU directly would reduce headline GDP growth, though its impact on per capita GDP growth, a more important indicator of prosperity, is less clear cut. (High earning migrants contribute more to GDP per capita than those on lower pay.)

Most economic models assume that a more distant economic relationship with the EU will mean lower levels of inward investment and competition and reduced specialisation, and, therefore, lower long-term growth. Thirteen separate economic assessments of the impact on UK growth of operating under a free trade agreement showed an average reduction in the long-term level of GDP of 4.0%. The fact that some, much shorter-term Brexit risks, have failed to materialise, such as the Treasury forecast that a vote to leave the EU would trigger a recession or estimates of large job losses in finance, underscores the speculative nature of even longer-term forecasts.

The UK-EU deal is not the end of the Brexit story. Under the deal the UK will need to establish a new regime for monitoring subsidies and environmental enforcement. Both sides have the right to challenge the other on state aids and other 'level playing field' issues. Fishing will be back in the headlines in 2026 when the first annual UK-EU talks on quotas take place. Meanwhile May's elections to the Scottish Parliament will be a test of the SNP's dual commitment to an independence referendum and re-joining the EU. The pandemic and Brexit seem to have sharpened the Government's appetite for reform. The challenges are formidable – recovering activity lost in the pandemic, rebooting productivity, spreading prosperity across the UK and delivering a vast energy transition.

It is a well recited statement that markets like to climb a wall of worry, and there is certainly much to occupy us over 2021. Infection rates are picking up and the advent of colder weather and a release from the November lockdown has triggered a more meaningful second wave. Markets seem to be taking much of this news in their stride and barring a spate of disappointing news on the actual distribution and efficacy of the various vaccines, we enter 2021 with high hopes of a better year for markets and maybe, just maybe, the UK market can be at the forefront.



Portfolio Changes Over the Quarter

In the early part of the quarter, we sold the holding of the **iShares TIPS ETF** and switched into the **iShares $ Treasury Bond 7-10-year ETF**. Both funds are similar in that they hold US Government Bonds and they offer exposure to the US Dollar. They also have similar interest rate risk, meaning that changes in interest rates will have a similar impact on the two funds. The key difference is that the fund sold holds inflation-linked bonds, meaning the income from the bonds is linked to the Consumer Price Index, whereas the fund we purchased holds conventional bonds, which pay a flat annual income. The index-linked bond will tend to outperform when inflation expectations are increasing and underperform when they are falling.

We introduced the TIPS fund into the portfolio towards the end of the second quarter when we thought inflation expectations were too low but looked to be trending higher. Inflation expectations then continued to trend higher after we purchased the fund, which worked in our favour, but when the level started approaching the US Federal Reserve's target of 2% inflation, and with the world at the time looking set to enter a second wave of COVID (which will likely be quite deflationary in the short term) we decided to sell the TIPS fund.

At the same time, we also liquidated the holding of **Invesco STOXX Europe 600 Fund**. The fund was purchased when we were seeing signs of a strong bounce back in the European economy, particularly in the manufacturing sector, and also because we expected the European companies in the STOXX 600 Index to benefit from the European Union's EUR 750bn recovery plan that had just been announced. However, we then started seeing signs of the recovery faltering and shortly before the sale we were seeing figures for industrial production in Germany that were particularly weak. Also, the rate of new daily COVID-19 cases per million in Europe had recently moved above that of the US and cases in Italy in particular had moved sharply higher, so we decided to reduce exposure to European equities.

We used the proceeds to purchase a holding of the **L&G Global Real Estate Dividend Index Fund.** This is a low-cost passive fund offering exposure to the shares of property companies and Real Estate Investment Trusts (REITS). Prices for these assets still remain significantly below their pre-COVID levels, and in our opinion offered an attractive level. Shares in the real estate sector also tend to perform relatively well in an environment of falling growth with potentially falling inflation, which is what we were seeing at the time.

Towards the end of October, we made a defensive change by reducing US equity exposure a little. Equity markets had been exhibiting a higher level of volatility than usual on fears that worsening COVID-19 case numbers may make stricter lockdown measures unavoidable. Also, uncertainty over the outcome of the upcoming US presidential election (including the potential for a contested result), and how this will impact the expected £2trn US COVID relief plan, were also weighing on markets.

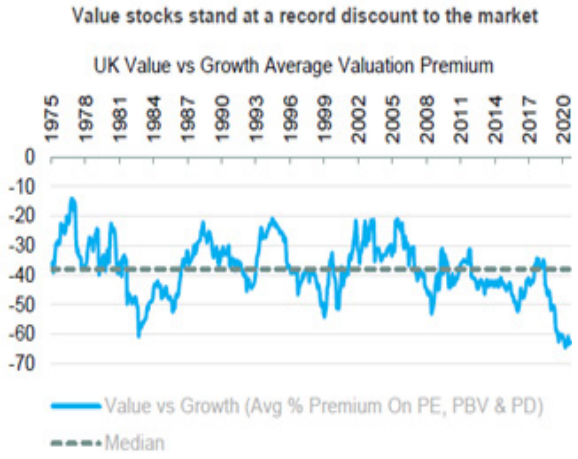
We expected this volatility to continue into the following week around the election, so we felt it prudent to take a little risk off the table. Given that we expected much of the volatility to be focussed on US equities we decided to sell the holding of **iShares S&P 500 Consumer Staples ETF.** This fund was purchased as a defensive position in March when equity markets were looking particularly fragile. It holds US companies such as Proctor & Gamble, Walmart and Pepsi. The price held up well during the COVID-related market selloff, and the price then gradually moved higher during the summer. It then started to underperform and was not proving to be as defensive as we would usually expect from consumer staples stocks. We therefore took the opportunity to sell and book a c. 15% profit on the trade.

Rather than reinvest the sale proceeds immediately we were comfortable to temporarily hold a slightly higher cash level than is usually the case, until the investing landscape became a little clearer once the dust had settled from the US election.

During November we decided to rebalance the portfolio, to bring each position back to its target weighting, and we took the opportunity to make some further changes. We used the cash raised from the recent sale of the Consumer Staples fund to bring a new fund into the portfolio, the **Invesco NasdaQ 100 ETF**. The Invesco fund offers exposure to the 100 largest non-financial companies listed on the NasdaQ Stock Exchange, which is heavily weighted towards technology companies. The fund counts Apple, Microsoft, and Amazon amongst its largest holdings. Technology stocks reacted positively as it looked more likely that Joe Biden would win the US Presidential election, but that Republicans would retain a Senate majority. The absence of a 'blue wave', with both chambers in Congress controlled by the Democrats, was perceived to reduce the ability for Biden to push through tax hikes and crack down on 'big tech'. We therefore responded by increasing exposure to US technology stocks.

With equity markets looking to be in a strong uptrend, helped by a string of positive vaccine news, and looking ahead to a strong economic recovery next year, we made some further changes to the portfolio to increase equity exposure. We have done so in a selective way by focussing on UK equities that are classed as showing 'value'. There are many different definitions of what represents value but generally it is interpreted as shares whose price is relatively low versus their fundamentals (e.g earnings and book value). This contrasts with 'growth' stocks, which generally have higher growth in their earnings, but whose prices are typically much higher in relation to their fundamentals.

Over the very long term, value stocks have outperformed growth stocks, but the opposite has occurred over the past decade or so, which in the UK has pushed value stocks to stand at a record discount to the market on some measures. On top of this the UK equity market is still very unloved as international investors shun the market, most likely due to uncertainty surrounding the outcome of Brexit, which should make the current price levels attractive.

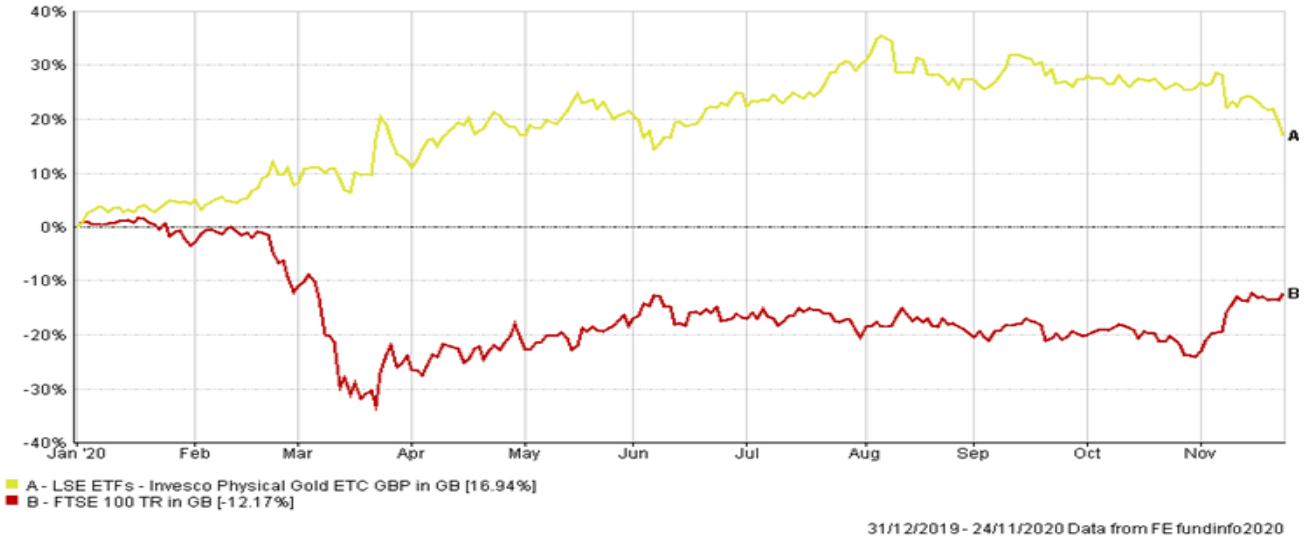


Source: RWC 31.8.2020

There are some signs that the recent trend of growth outperformance may be reversing, partly because value stocks offer exposure to sectors and industries that were hit hardest by the economic downturn caused by COVID-19, such as energy and banking. These are the areas of the market that are bouncing back the strongest following the positive vaccine news, but whose year-to-date performance still stands at a significant discount to sectors such as technology that have done the best. Further reasons to favour value stocks were that they have historically outperformed when an economy is moving out of a recession.

Exposure to UK value stocks has been achieved via the purchase of two new funds: **Man GLG Undervalued Assets Fund** and **JOHCM UK Dynamic**. Both funds are actively managed, which we feel to be important for this type of exposure. They are also both run by a strong and experienced team, but with very different investment approaches, and we feel they complement each other well.

The new purchases have been funded by reducing exposure to some existing funds offering UK equity exposure (but without the value-focus) including **Royal London Sustainable Leaders Fund**, which has had a very strong performance over the past couple of years. We have also reduced the gold exposure in the portfolio. Gold has also enjoyed a strong performance over the past couple of years and performed particularly strongly during the COVID-related equity selloff in March (see chart below). We have retained a core exposure to gold within the portfolio for diversification reasons. However, we note that gold funds had recently suffered significant outflows. This is not unusual because gold is often viewed as a safe-haven asset, which can cause its price to fall back when markets enter a more risk-on period. Gold also tends to underperform when bond yields are rising (which makes gold less attractive as a non-income producing asset).



In summary it has been a challenging quarter with lots to contend with, including a second wave of COVID, the US Presidential Election, as well as continued uncertainty around the outcome of Brexit, however the changes we have made have helped the portfolio enjoy strong performance over the quarter.