MANENTIA WEALTH CONSULTING GROUP

Quarterly Market Overview
3Q 2020

<u>October 2020</u>

MWC Group

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“At a crossroads”

It is as true metaphorically as it is true physically when we put one foot in front of another, that at every point in our lives, every step we take is at a crossroads and the path that we choose can lead to outcomes that range from the merely mundane to the truly tumultuous.

In the economic and the geopolitical arenas, we are faced with a multitude of crossroads immediately in front of us. From the looming US Presidential election to what the virus may yet have in store for us and the economic ramifications of further lockdowns, to US-China trade relations. There are others, but we mention the main themes.

At the depths of the Covid crisis, the financial markets had very rapidly priced in the worst-case scenario: that of an unknown contagion whose morbidity was a wild guess at best afflicting a civilisation wholly unprepared for such a scenario.

The equally unbelievable bounce off the March lows to the August highs priced in the best case scenario where, having spent the best part of spring lounging on the sofa and playing video games, doing DIY or taking up online trading, the economy was supposed to just get up and carry on where it had left off, as if nothing had happened.

We all know that the truth lies somewhere in between. Whether there is a second wave of infections, whether the approaching winter in the Northern Hemisphere will exacerbate infections or whether a vaccine will be developed are all still unknown. What is known, however, is that despite the high transmission rates and the nastiness of the virus, it is not the killer initially feared. Whether we get herd immunity or an effective vaccine to end the curse, only time will tell, but the virus is no longer the main danger to a global economic recovery - it is policy response to it that we must now be wary of, and perhaps even fear.

Western democracy is not set up to deal with these situations well. As we foresaw in our 1Q20 commentary, the democratic process has too many vested interests to allow for a rapid, pragmatic and effective response to the threat posed. Look at the US for example: in the run up to the election, the wrangling continues in Congress between the two parties as to the size and direction of the next stimulus package. It is as if the needs of the people have become secondary to the 'bargaining chip' that the stimulus has become.

Bear in mind that as economies grow and mature, more and more of the national effort goes into providing services as increasing costs of labour push manufacturing to offshore and cheaper locations. In large and mature economies such as Europe and the US, the effects of the lockdowns have been most acutely felt in the bedrock of the economies: the small businesses and private enterprises that make up a large and essential part of the services sector. The wrangling that is going on in Congress is about who should get support and how much. We believe that a new fiscal stimulus package will eventually be passed, but when and by whom remains to be seen.

We fear that with the economy in the state that it is in currently, and with fiscal stimulus shut off, rising insolvency and normal recession characteristics could begin playing out. With Congress currently in a gridlock, and the economy having ridden off a fiscal cliff at the end of July, nearly 30 million Americans are no longer receiving those extra federal unemployment checks that they had been receiving since April, and instead are receiving the normal level of state unemployment aid. In addition, those one-time stimulus cheques that both employed and unemployed people received are long-since spent. Left unaddressed, this will eventually translate into more insolvency, such as a greater percentage of missed housing payments and a decline in overall consumer spending, and thus a possibility of W-shaped economic data, another deflationary shock, and more traditional recession effects being felt by more people.

We feel that with the damage that has already been done, the secondary effects of the lockdowns will become more apparent within a system that was never expected to have to cope with the kind of stress to which it has been subjected. Since most fiscal stimuli enacted back in the Spring have largely expired, or have otherwise terminated, we see the effects in the PMI (Purchasing Manager's Index – a forward looking, or *leading*, indicator of near-term economic activity) data now being released. As Bank Julius Baer recently reported:

> ***FLASH PMIS: ACTIVITY STALLS IN SEPTEMBER, CHALLENGES RECOVERY***
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> *Preliminary purchasing manager indices (PMIs) in Europe showed that the resurging coronavirus cases and tightening of containment measures pushed the services sector activity back into contraction, emphasising the fragility of the recovery in times when the pandemic is not yet fully controlled. Manufacturing momentum held up better, but will be challenged should the recovery falter further. In the US, momentum looks more stable, while Japan struggles to regain growth territory.*

Although the US PMI data currently appears to be more stable, its services sector is much larger than elsewhere and a further slowdown there would be a heavier blow to the economy. If, or perhaps, *when*, this transpires, the government will then face a choice: to continue to provide financial support to those who have permanently lost their livelihoods or to spend that money on rebuilding the economy from the ground up. We hope, regardless of whoever wins the election, that the US embarks on a program of infrastructure works that will create new jobs and lay the foundations of a strong economic recovery. It will be money well spent. Europe, and particularly the UK, will face similar choices.

If the policy decision, however, is to continue to provide handouts, it risks entrenching a 'Zombie Economy' where unproductive capital is deployed into an unproductive portion of the labour force causing sovereign debt to rise and nothing to show for it in contribution to GDP. This is one of the pre-requisites for stagflation – short for stagnant economy with inflation – and a situation last encountered in the 1970's.

Don't fight the Fed

The U.S. Federal Reserve's move to target average inflation is a significant shift. We believe it should lengthen the economic expansion and delay the day of reckoning for equity markets from higher interest rates. The Fed will now allow an overshoot of its 2% target if inflation dips below the target for some time (and as it has done for the last decade and more).

The Fed's preferred measure of inflation, the core personal consumption expenditure deflator, rose 1.3% in the 12-month period to 30 June, 2020. This 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. We're not convinced that governments will be in a hurry to implement fiscal austerity. It's not a winning electoral strategy and the current ultra-low borrowing cost makes high debt levels more sustainable. We believe the debt/GDP ratio can be stabilised provided the interest rate paid on debt is lower than the growth rate of trend nominal GDP1 - which is something that holds for almost every major economy as we move into the fourth quarter. 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 years away.

US Outperformance

A surprise 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 Index 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. These tailwinds could soon become headwinds. Barring a second round of lockdowns, global bond yields have probably seen their lows and the near-term boost to technology stock earnings from lockdowns has peaked. This should allow the normal recovery dynamics to resume, with investors potentially rotating toward relatively cheaper value and non-U.S. stocks that will benefit from the return to more normal economic activity.

United Kingdom

Brexit uncertainty dominates the 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. Our 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. We like the value in the UK market on a longer-term basis.

Deglobalisation to continue

…whoever wins the US election.

With the US election result likely to have limited near-term implications for world GDP, the main issue for the global economy is how it affects US trade policy. We presume that Joe Biden would take a less aggressive approach, but we also think that he would not prevent a further decoupling with China or the stalling of globalisation in its current form, more generally.

We think that globalism is not dead, but it is evolving. It has to, else it will *not* survive.

While globalism has benefitted billions of people around the world, it has left others behind and we need to adjust for the unintended consequences. Much of this work should fall on the shoulders of multinational corporations, which will increasingly need to address the issues that they were in part responsible for creating during the most recent phase of globalization, if they want to continue to have a license to operate.

While much of the focus in geopolitics is on US-China tensions, there are other relationships – such as those between the US and the EU and between China and India – that are significantly impacting the way corporations need to run their businesses. The world is being reshaped, and multinationals need to adjust. That means an increased focus on providing local employment opportunities, respecting different data sovereignty preferences and complying with a diverse set of jurisdictional rules. The bottom line for tech companies: The days of unfettered access to markets with little regulation are most likely gone.

One thing that's become clear is that the notion of a physically enclosed enterprise is over. Corporations will need to allow employees to work from anywhere, and the technologies required to make that happen are going to be very important. This change will obviously impact corporate real estate footprints, and it's going to profoundly impact the hiring process as well. When employees are untethered from corporate headquarters, that's going to open up access to a lot of talent. And we're almost certainly looking at less business travel in the future: The days of a 13-hour flight for a two-hour meeting are probably behind us.

US Election

We will refrain from opining on the outcome of the US Presidential election as there are plenty of media column-kilometers available to read elsewhere, and we feel we have no particular insight that adds to the dialogue.

Nevertheless, we expect that this race will be the most contentious since the Gore/Bush Jr. experience of 20 years ago. With the divide between the Republicans and the Democrats never wider and the 'if you're not with me, then you're against me' mantra ever pervasive in American society, we can see this contributing to volatility in the markets. Indeed, options pricing already indicates that the 'implied volatility' of buying protection up to November is higher than the cost for up to October. Normally, it is the other way around with the longer the tenor, the lower the implied volatility.

The anticipated volatility is likely to increase as we approach election day with no certainty that calm will be restored on the morning of the 4th of November. With the threat of litigation hanging over the results of the votes cast, there is no guarantee that we will have an outcome immediately.

Does it end up in the courts? Who knows. Let's wait and see.

Data Table

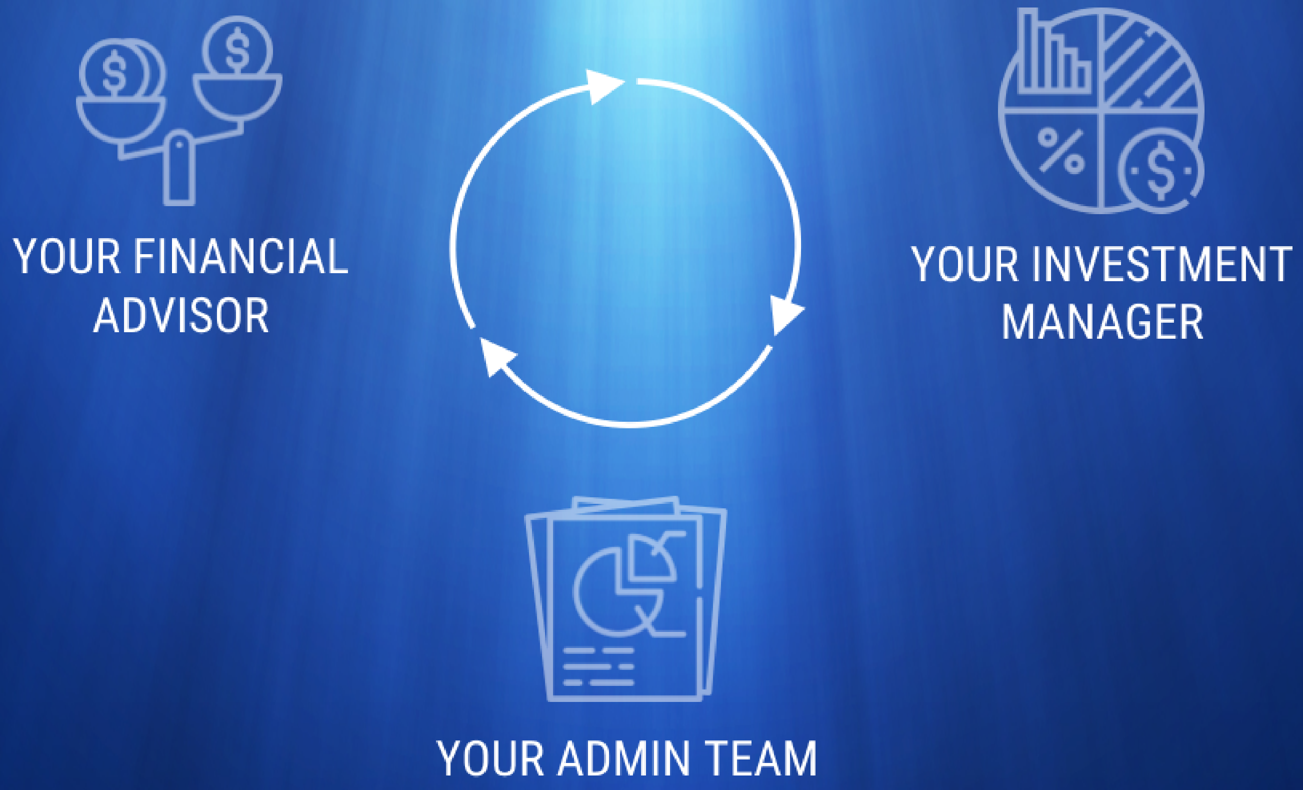
October 2020

Stock Markets	Month	Q3 20	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	-4.71%	7.59%	3.24%	-9.00%	0.25%	1.30%
Euro Area	-2.41%	-1.25%	-14.73%	-14.70%	0.00%	-0.20%
Germany	-1.47%	3.19%	-6.46%	-11.30%	0.00%	-0.20%
France	-2.91%	-2.69%	-19.65%	-18.90%	0.00%	0.10%
Italy	-3.15%	-1.86%	-19.11%	-17.70%	0.00%	-0.50%
Spain	-3.63%	-7.12%	-29.66%	-21.50%	0.00%	-0.40%
Greece	-1.46%	-2.21%	-31.85%	-15.20%	0.00%	-1.90%
Switzerland	0.51%	1.41%	-4.05%	-8.30%	-0.75%	-0.90%
United Kingdom	-1.63%	-4.92%	-22.23%	-21.50%	0.10%	0.20%
Brazil	-4.80%	-0.48%	-18.20%	-11.40%	2.00%	2.44%
Russia	-2.04%	5.93%	-4.60%	-8.00%	4.25%	3.60%
India	-1.45%	9.03%	-7.72%	-23.90%	4.00%	6.69%
China	-4.75%	10.17%	11.98%	3.20%	3.85%	2.40%
Japan	0.20%	4.02%	-1.99%	-9.90%	-0.10%	0.20%
MSCI World Equity Index	-3.37%	7.67%	-0.02%			

Bond Indices	Monthly	Q3 20	YTD
Barclays Capital U.S. Aggregate Bond Index	-0.27%	-0.14%	5.20%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	0.78%	0.80%	2.85%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	-2.10%	0.33%	-9.32%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	0.40%	-0.04%	1.59%

Currencies	Monthly	Q3 20	YTD	Price
EUR/USD	-1.83%	4.32%	4.51%	1.17
GBP/USD	-3.39%	4.15%	-2.60%	1.29
EUR/GBP	1.60%	0.11%	7.31%	0.91
USD/CHF	1.90%	-2.81%	-4.89%	0.92
EUR/CHF	0.06%	1.41%	-0.58%	1.08
USD/JPY	-0.42%	-2.30%	-2.92%	105.45
GBP/CHF	-1.52%	1.26%	-7.40%	1.19

Commodities	Monthly	Q3 20	YTD	Price
Gold	-4.28%	5.82%	24.26%	1885.44
Oil (WTI Crude, NYMEX)	51.19%	140.11%	-34.21%	40.17



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