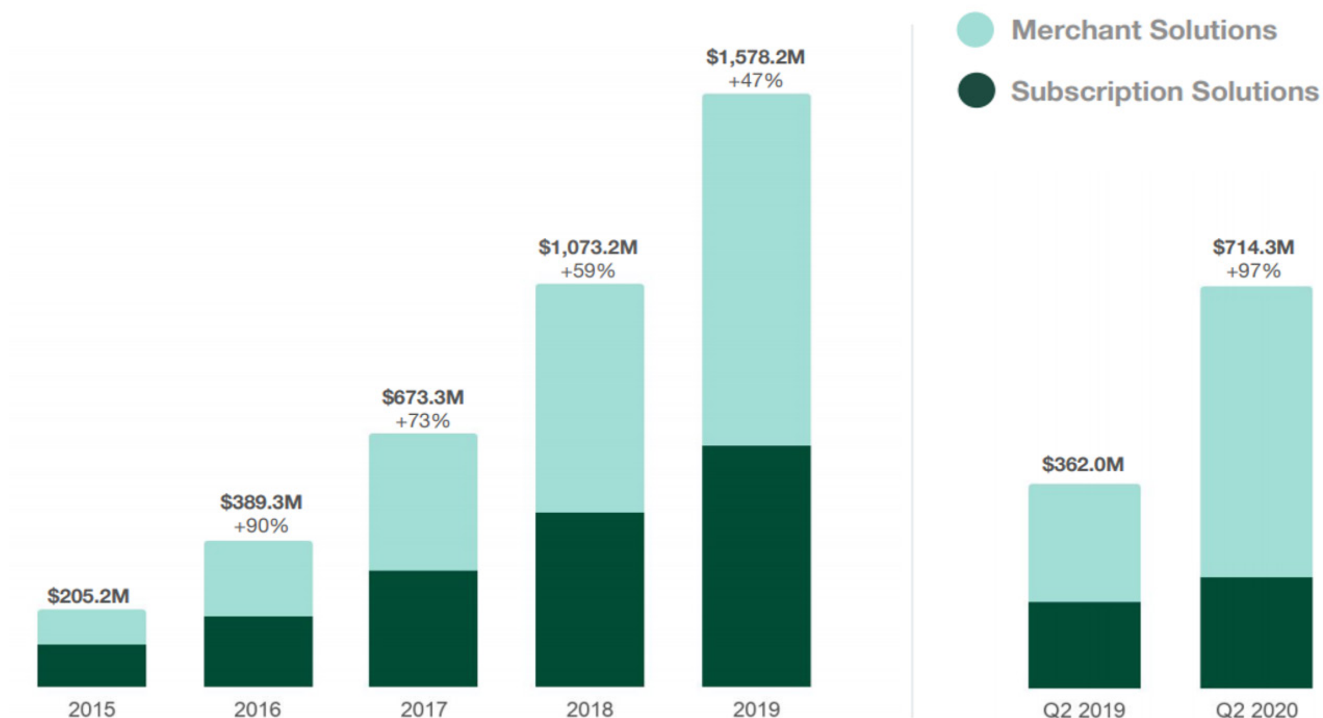
History informs us that great crises bring great change, and they dramatically accelerate trends already underway. WWII led to the foundation of the welfare state and an era of multilateralism, with the creation of the United Nations and the European Coal and Steel Community, the forebear of today's European Union. The global financial crisis gave us negative interest rates, financial repression and the blurring of lines between central banks and governments.

Today's crisis has yet to run its full course but already we can see some of its structural and far-reaching impact. Trends already underway, the growing dependence on technology, the weakening of international bodies, rising inequality, anti-globalisation and the rise of nationalism, the shift of economic power to Asia, the clash between the established super-power, the US, and the rising challenger, China, now an increasingly ideological battle, are all moving forward more rapidly.

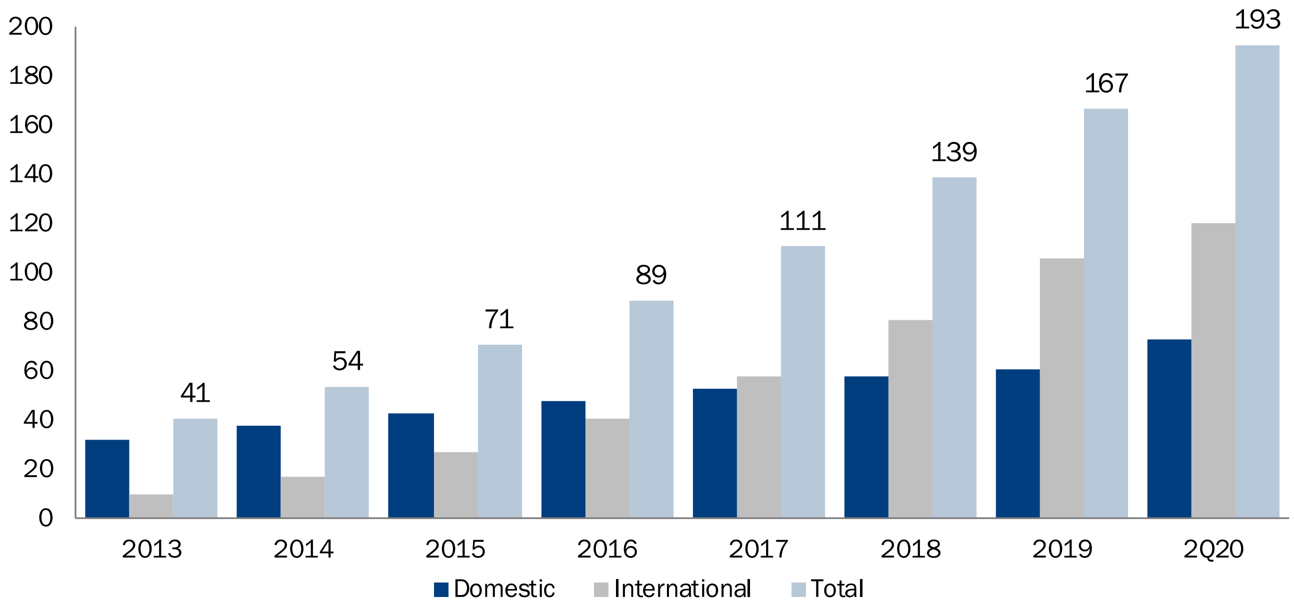
At the same time, the changes in working habits of the past decade, the rise of self-employment and more flexible working arrangements, are now seeing a potentially era-defining shift towards working from home, with untold consequences for real estate markets and spending habits. Perhaps most importantly, the encroachment of the state in the economic affairs of the nation has taken a dramatic step forward, and we are surely a step closer to direct monetary financing of government debt.

The Pandemic has accelerated growth in ... E Commerce Sales



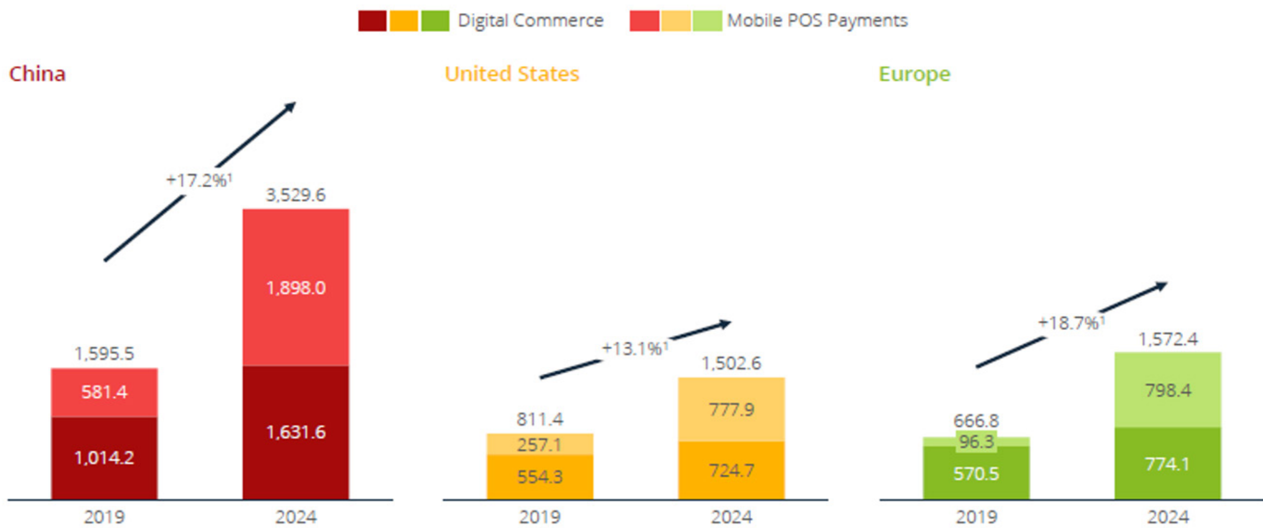
Source: Shopify, Jennison Associates

Media Subscriptions



Source: Netflix, Jennison Associates

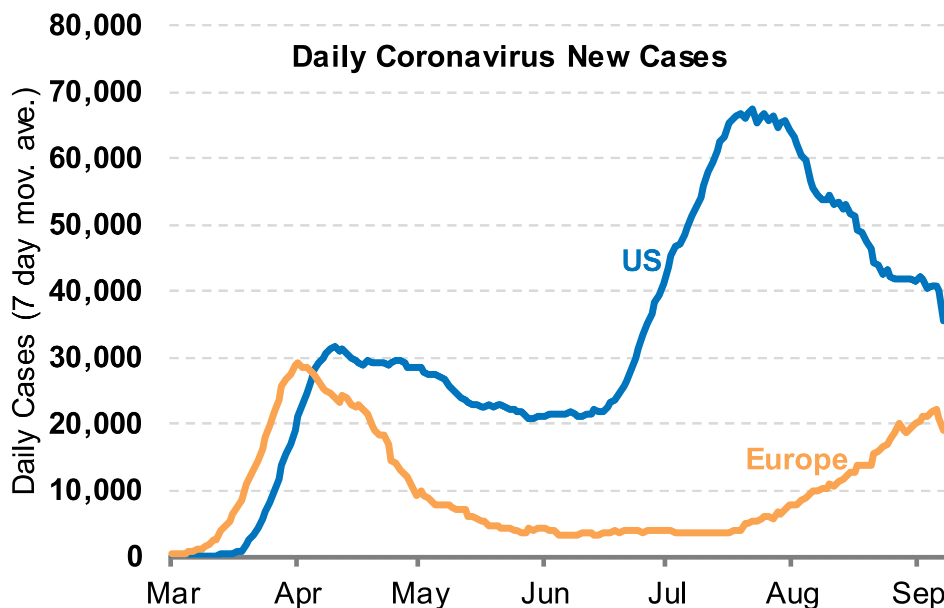
Digital Payments



Source: Statista Digital Market Outlook 2020, Jennison Associates

These changes create uncertainty, but at the same time opportunity. But first, we need to see out the pandemic. As we approach winter in the northern hemisphere, home to 90% of the world's population, fears are rising that a second wave, potentially more deadly and economically damaging than the first, is approaching.

I do not share that prognosis. We know much more about the virus now; we have identified the vulnerable and how best to protect them; we have a much-improved understanding of how it can be treated; and healthcare systems are better prepared. Encouragingly, while cases have risen in many countries, hospitalisations and deaths have remained relatively low. It is the young who are mainly contracting the virus now, and they are at much lower risk of becoming seriously ill. As testing capacity is ramped up, and contact tracing is rolled out, the ability to identify outbreaks rapidly and control them locally is much improved.

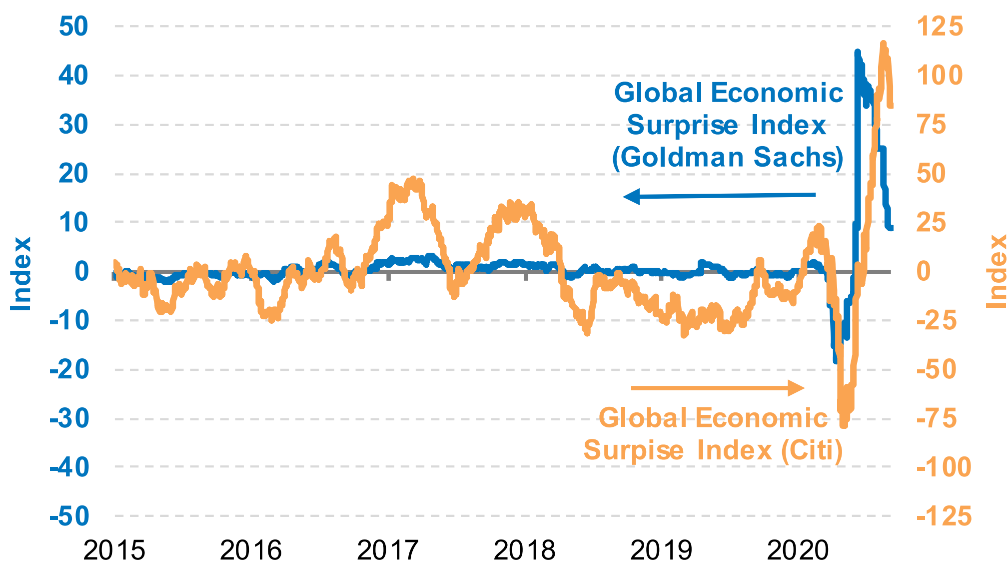


Source: Bloomberg, BMO Global Asset Management

Although fear prevails, and a re-imposition of certain restrictions in many countries is probable, I see very low risk of a return to full-scale nationwide lockdowns. A social lockdown, yes, a full economic lockdown, no; the damage caused would be substantially higher than by the virus. In the meantime, the strive to find a vaccine has resulted in extraordinary achievements. There are 7 vaccines in phase 3 clinical trials; safety tests have been cleared and everything now depends on the trials. The Oxford vaccine is the front runner, considered to be 3 to 4 months ahead of the rest, and could be ready by year end. There is no certainty, but this vaccine can be produced in substantial quantities relatively cheaply; Astra Zeneca already has global manufacturing capacity of 3 billion doses. The omens are good. Don't rule out the possibility of a mass vaccination programme in a matter of months. As Steven Bell explained, that would be a game-changer, and is by no means discounted in markets.

The economic impact of the virus has been catastrophic, with record breaking falls in GDP. The depth and breadth of the shock has been extraordinary, with both the demand and supply side of economies damaged, and the biggest burden falling on the usually resilient services sector, by far the largest component of developed world economies. Aggregate corporate profits have collapsed, companies have adopted cash preservation and survival measures, and dividends have been slashed.

Yet none of this has come as a surprise to investors; most of it had already been discounted; the 35% fall in global equities between late February and late March accurately foresaw the scale of the damage. What matters now is the speed and durability of the recovery underway, and the risks of it being derailed.



Source: Bloomberg, BMO Global Asset Management

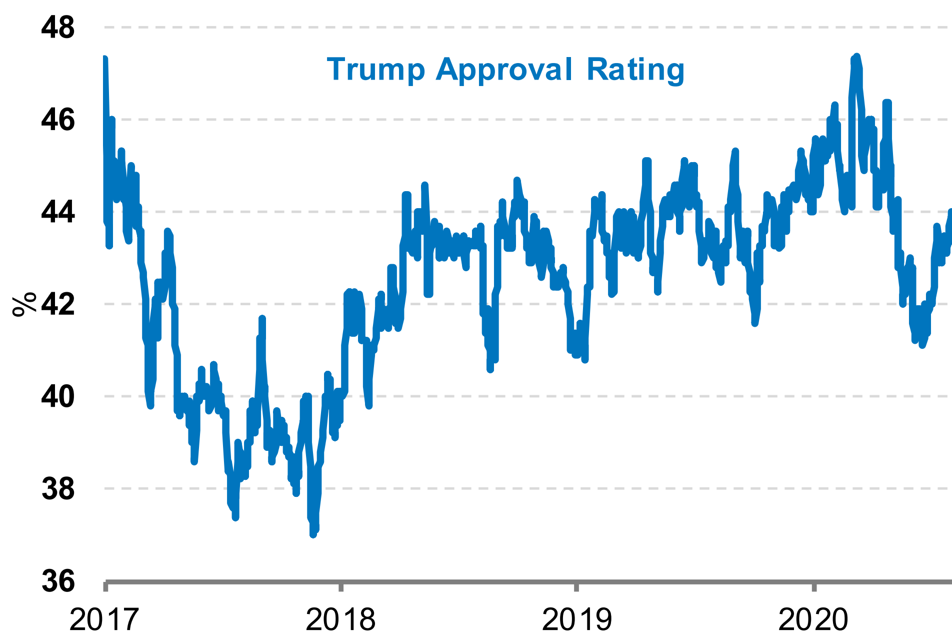
To date, economic activity has recovered more rapidly than initially feared. Steven illustrated this well with leading indicators and high frequency data, and pointed out that China, first into the crisis and first out, is now back to pre-pandemic activity levels. The US, UK and Europe have also recovered well, albeit to levels which are well below those of January. The release of pent-up demand has boosted consumer spending, manufacturing and construction are making up for production lost or delayed, and the digital economy continues to grow strongly. Social distancing and other measures to control the virus restrain a return to full normality and mean that some parts of the economy remain depressed, while other important sectors such as banking, energy and real estate face serious headwinds as a result of policy actions or changes in behaviour. But on balance, the recovery in economies since the April lows has been more rapid and sustained than anticipated. A good illustration of that came from the Fed last week, when it revised its GDP forecast for 2020 to a decline of 3.7% compared with its June forecast of a decline of 6.5%.

However, there are risks to the sustainability of the recovery. The virus is not yet beaten; second waves might become damaging and hopes for a vaccine could disappoint or be derailed by the logistical challenges of its roll out. Government debt has exploded due to increases in healthcare spending, reduced tax as recession took hold, and fiscal support measures for employees and businesses. As the furlough schemes and other emergency packages begin to tail off, economies face something of a moment of truth: to what extent has the recovery to date been supported by these extraordinary measures, do we now face a surge in unemployment with resulting damage to confidence and spending?

Then there are the longer-term ramifications of the virus. The scale of the debt built up by the public sector is a headwind to growth in the years ahead, limiting policy flexibility. There are likely to be behavioural changes; individuals and businesses will be more cautious and build up precautionary savings, restraining spending and investment. Some sectors have been permanently scarred and face structural challenges verging on existential. Supply chains are being re-planned, with security and diversification of supply over-riding cost. All this comes at a time the world was already facing slower growth resulting from demographic changes and the end of the great global trade bonanza of the past 30 years and China's extraordinary growth surge as it integrated into the global economy. There is nothing on the horizon to match that transition.

While the virus has dominated everything this year, there are other hurdles to overcome. Foremost are the US-China relationship, the Presidential election, and Brexit.

The direction of the US-China relationship could be determined by the outcome of the election. Another term for Trump would see a further escalation of the dispute, whereas Biden would be less protectionist and more willing to re-engage internationally. Nevertheless, the trade issue has bipartisan support and anti-China sentiment has grown significantly, so any measures to roll back tariffs are very unlikely. On current polling, Biden will be the next President and the Democrats will have control of Congress. But Trump came back from larger polling deficits in 2016, his rating has picked up in recent weeks, and he is polling higher than Biden in two key areas, the economy and law and order. The outcome is by no means a foregone conclusion. Biden is the least market friendly of the two; he plans to raise taxes on companies and higher earners, and roll back Trump's deregulation agenda, so the equity market could be under a cloud if polls continue to show a clean sweep for the Democrats. But in practice there would probably be little lasting impact, with both candidates intent on big fiscal spending and the Fed firmly committed to ultra-loose policy.



Source: Bloomberg, BMO Global Asset Management

Brexit is now entering the business end of the negotiations, and with it a game of high politics. The EU continues to struggle to come to terms with the fact of the UK's departure, but recognises that a Prime Minister with an eighty seat majority in Parliament can and will implement his agenda, something that Prime Minister May was incapable of doing. The UK government, on the other hand, is intent on sticking rigidly to self-imposed deadlines, the latest being October 15th to conclude free trade negotiations, while wriggling with a withdrawal agreement that it sees as heavily favouring the EU.

The particularly unusual point about these negotiations is that the starting point, an existing free trade agreement between the UK and the EU, is also where both sides want to end up. But in reality, continuation of the status quo is not possible as the UK has chosen to leave the single market and customs union and the EU is immovable on issues concerning the integrity of their market. While the negotiations have gone backwards in recent weeks, much has in fact been achieved and there are few areas where agreement has not been reached. Naturally, these are the toughest matters where the two sides are furthest apart, but as with all things related to the EU, it will come down to the eleventh hour.

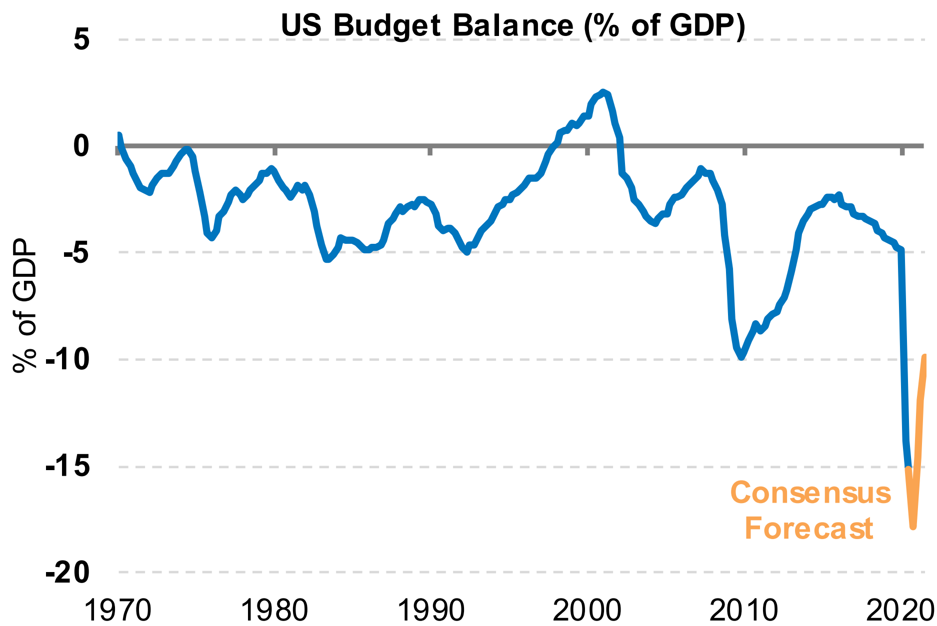
The most likely outcome is a basic agreement which enables tariff free trade, but with much left for further detailed negotiation beyond the formal end of the transition period on 31 December, a deadline which the UK government will not extend. That outcome would be a relief to markets, the alternative being no deal and the UK trading with the EU on WTO terms. Under those circumstances there would be some short term disruption and markets would wobble. However, sterling would take most of the strain and the UK equity market, dominated as it is by large global companies, with 75% of FTSE 100 revenues from outside the UK, would most likely be a beneficiary. Either way, we believe that the UK will prosper as an open, increasingly knowledge-based economy, free to forge its own trade agreements beyond the EU. What is clear is that the economic impact of covid far outweighs anything that Brexit might deliver, good or bad.

Against this background, what is the broad macro picture ahead and how should we be positioning portfolios?

Recovery from the economic slump of March and April is well underway and will continue. But it will take some time for the global economy to return to full normality, even with an early vaccine success, and longer term growth is likely to be subdued. Excess capacity, structural damage and weak demand has led to a deflationary environment and rising unemployment. Governments and central banks have responded with extraordinary policy measures and continuing support will be needed in the years ahead.

Central banks across the developed world have cut interest rates to near zero or below, and have committed to keeping rates at these levels for the foreseeable future; the Fed is projecting unchanged rates through 2023, while it is likely to be many years after that before the Bank of Japan and the ECB raise rates. Japan has already had interest rates at or below zero for 2 decades, the ECB for 8 years, and in neither case has inflation come close to reaching its central bank target on a sustained basis.

However, no central bank with negative interest rates going into this crisis has cut rates further, and others, notably the Fed and the Bank of England, are reluctant to move into negative territory. This suggests that short term rates are at or very close to their lower bound and have limited use in further policy easing. This will therefore fall to QE, asset purchases, which will continue for years ahead, below the emergency levels at the peak of the crisis but still very substantial. It is also clear that central banks are prepared to take risks on inflation, the Fed having changed policy to target average inflation over time, giving it the flexibility to overshoot its 2% target and allow the economy to run hot for a period.
The more limited room for easing monetary policy means that an increased burden to support economic activity and employment will fall to governments, with the added pressure of addressing rising inequality. There will therefore be no return to fiscal austerity; despite debt to GDP ratios across advanced economies rising by 20% this year to record highs of 130%, a move to fiscal sustainability will be cautious and gradual. Fiscal and monetary policy will become more closely intertwined, and central bank yield curve control to keep longer term interest rates low or even direct monetary financing of deficits is increasingly likely.

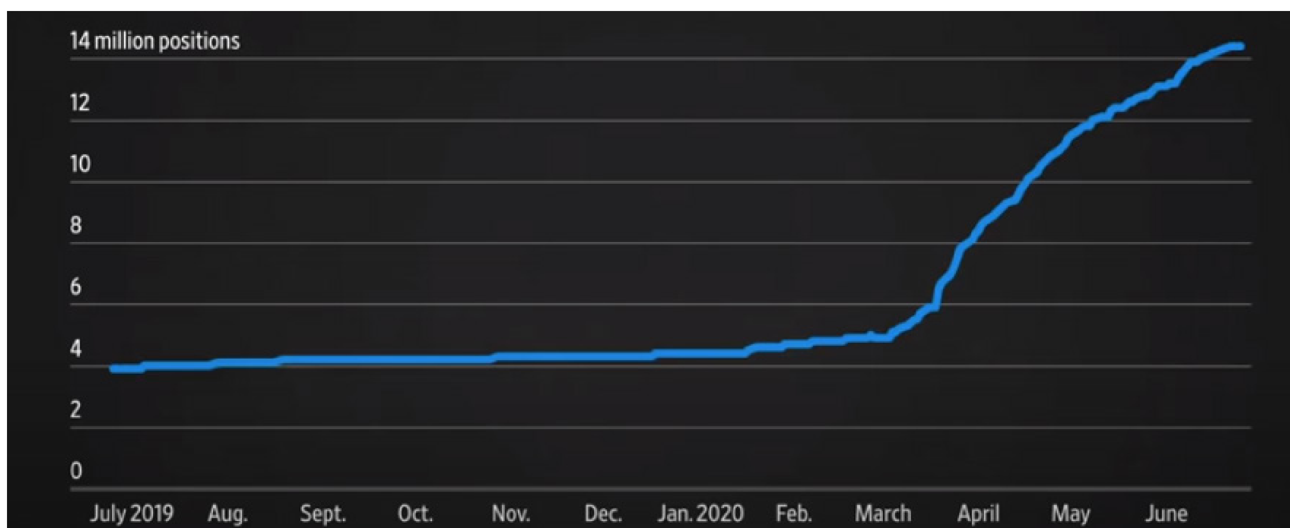


Source: Bloomberg, BMO Global Asset Management

In this environment, cash and safe haven government bonds will be a poor investment, delivering certainty of return of capital in nominal terms but, as Alex showed, losses in real terms. With the yield curve flat by historical standards, longer dated bonds offer limited yield pick-up compared with short term bonds, and there is a material risk of capital losses if yield curves steepen. This is increasingly likely as the world moves out of the pandemic crisis phase, which might well trigger a rise in inflation expectations. The risks in these bonds are asymmetric and it is important therefore to hold inflation protected bonds as well as a diversified portfolio of fixed income assets outside the traditional government area. Jean-Marie Dumas illustrated how the higher downside volatility of a range of factor style fixed income investing strategies should be more than compensated by higher returns while also offering diversification benefits.

Equities are likely to be the prime beneficiaries of the economic recovery and a long period of zero rates and QE, but they have risen sharply from the March lows. This raises the question of whether they are discounting much of the improved outlook. There is a strong case to be made that a period of consolidation is overdue, particularly in view of the uncertainties that lie ahead around the future course of the virus, and potentially market-moving events in the short term, Brexit and the US election.

Surge in Retail Buyers of US Equities

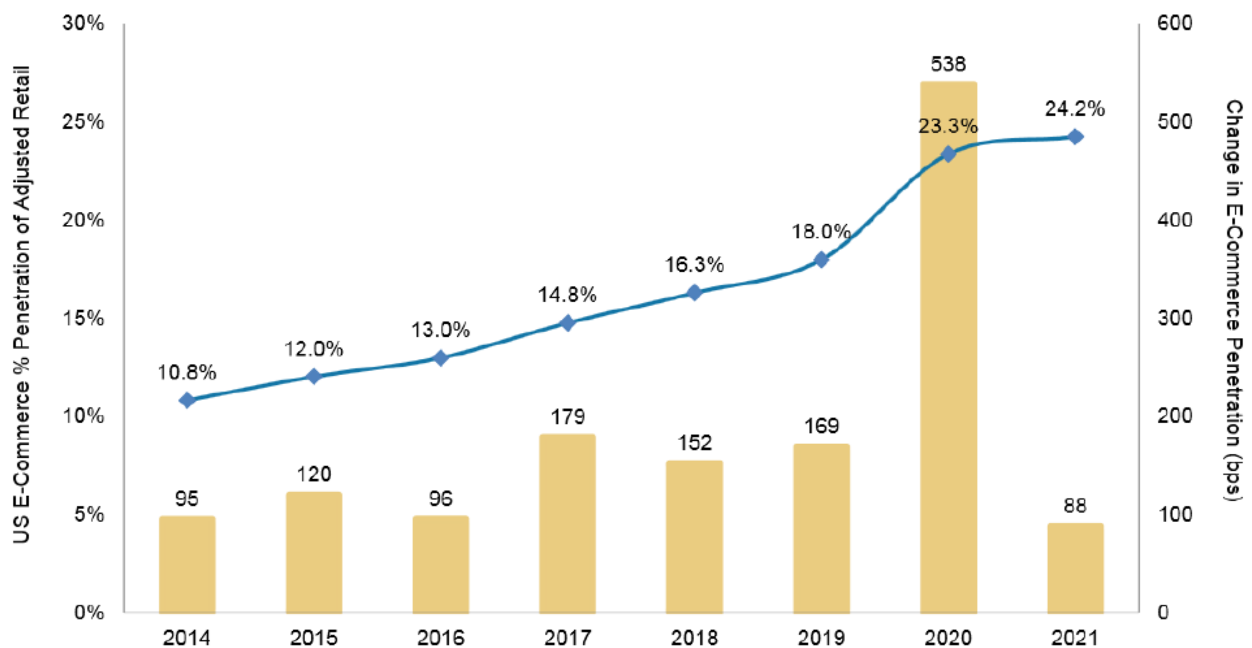


Source: Goldman Sachs, Granahan Investment Management

But it is important to recognise that the market has been driven higher by a narrow group of stocks, dominated by the FAANGs, now about 25% of the US market, together with the tech and digital stocks which have been the obvious winners from the pandemic. As Mark Baribeau and Drew Beja explained powerfully, these stocks are among the best secular growth stories, and none of us can be in any doubt after listening to these two world class managers that there should always be room in portfolios for stocks in this category.

But valuation does matter, and in many cases valuations have been driven to very high levels; while we are not seeing a re-run of the tech boom and bust of the early 2000s we have seen increasing retail and new buyers chasing momentum and we expect to see some rotation towards the depressed value parts of the market. It might be underway right now.

Increase in US E-Commerce Predictions

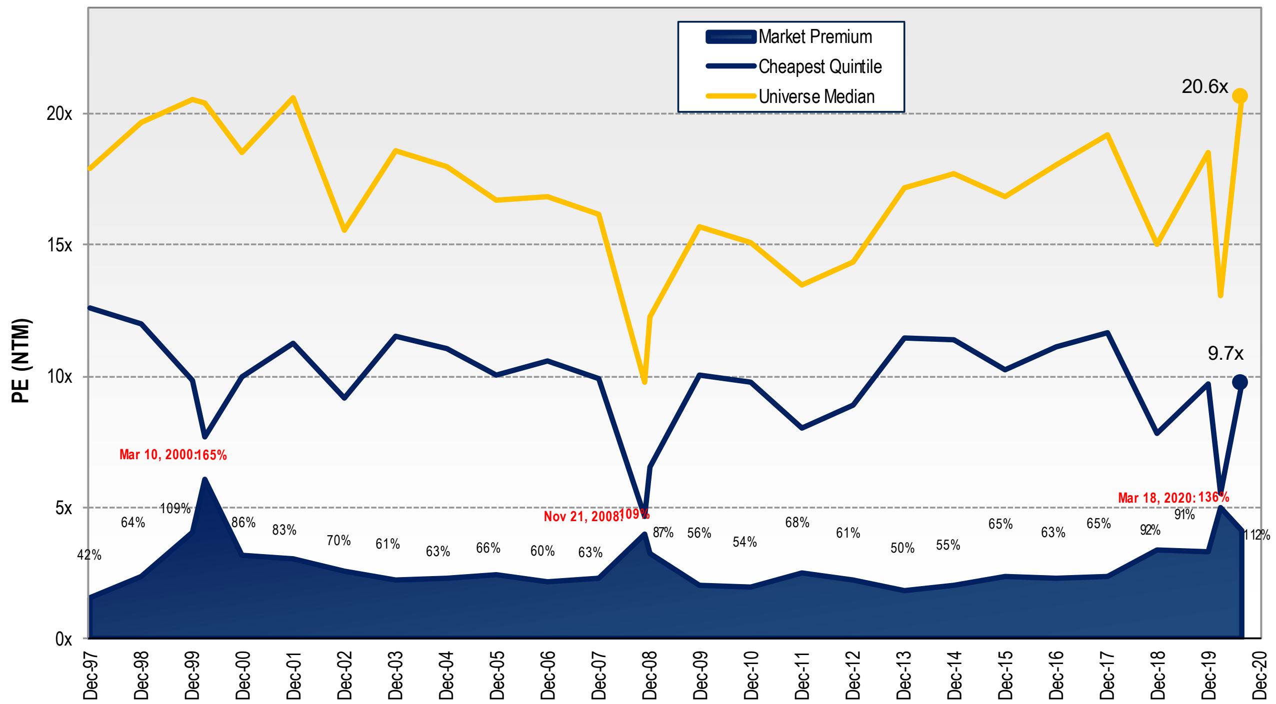


Source: Morgan Stanley Research, Jennison Associates

Andrew Wellington explained that the opportunity in this area is substantial: valuation spreads are wider than at the peak of the financial crisis and close to the widest in history. He illustrated how a deep downcycle in value is usually followed by a steep upcycle. He felt that the cycle might already have turned, and is looking for 'one of the best'.

A successful roll out of a vaccine and a rise in inflation expectations would underpin this type of rotation, and it could occur without necessarily causing the overall market to decline materially. We strongly believe that a blend of equity styles is an important part of portfolio construction, and never more so than now.

Valuation Spreads



Source: Lyrical Asset Management

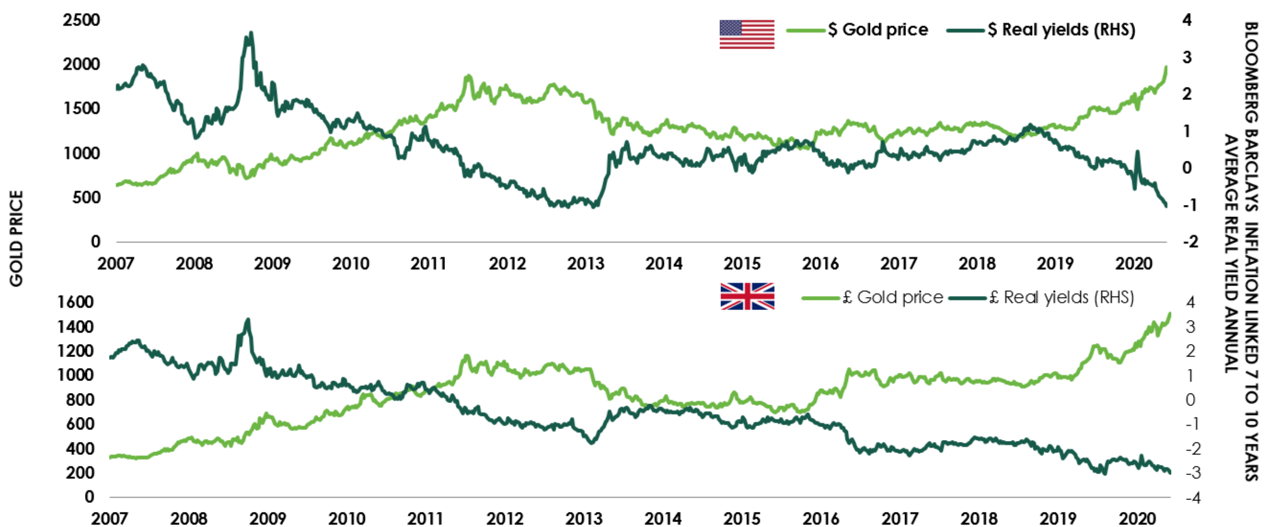
A challenge for us all in building resilient multi-asset portfolios is to find defensive assets that offer reasonable value, steady income and a buffer in difficult times. Property has served that purpose over the years but not in the current crisis. Parts of the retail sector are in permanent decline while the trend to work from home is casting a huge cloud over the future of offices.

Here in London, the big listed REITs that own vast office blocks across the City are trading at 50% or more discounts to net asset value. The trend towards working from home has accelerated and some companies will require a different type of office space, but I don't share the view that we are seeing the end of office working. There is a need for interaction, face-to-face meetings, spontaneity of conversation, learning from each other; it all fosters idea generation, staff development and team work, which can only be achieved when we work together in an office. Share prices in this sector have recovered very little and offer huge recovery potential. Similarly with infrastructure, which has been hit hard by the pandemic but which offers reliable revenue growth in most areas as well as a degree of inflation protection.

Inflation is not today's problem, nor might it be next year's given the spare capacity that exists, particularly in the labour market after this year's dislocation. But it is a longer term risk that is probably being under-priced. Unlike in the post-GFC period, when central bank liquidity injections were used largely to repair balance sheets of banks, this time the banks are in good shape and the dramatically bigger money printing has found its way into the economy. Money supply in the US has expanded by 20% this year, the highest for decades.

Historically such large increases have led to higher inflation. The economic recovery underway will eat into surplus capacity, and structural forces are no longer benign as deglobalisation and reshoring of supply chains could be inflationary. If central banks enter the world of direct monetary financing of government debt, inflation risks escalate. We think it is important to hold assets which protect against this risk; here, precious metals have a role to play and we continue to hold meaningful allocations across our portfolios. Ned Naylor-Leyland made a very convincing argument for gold's role as a store of purchasing power and its value as a decorrelating asset. And for those of you with the risk appetite he made an even more convincing case for silver and the miners.

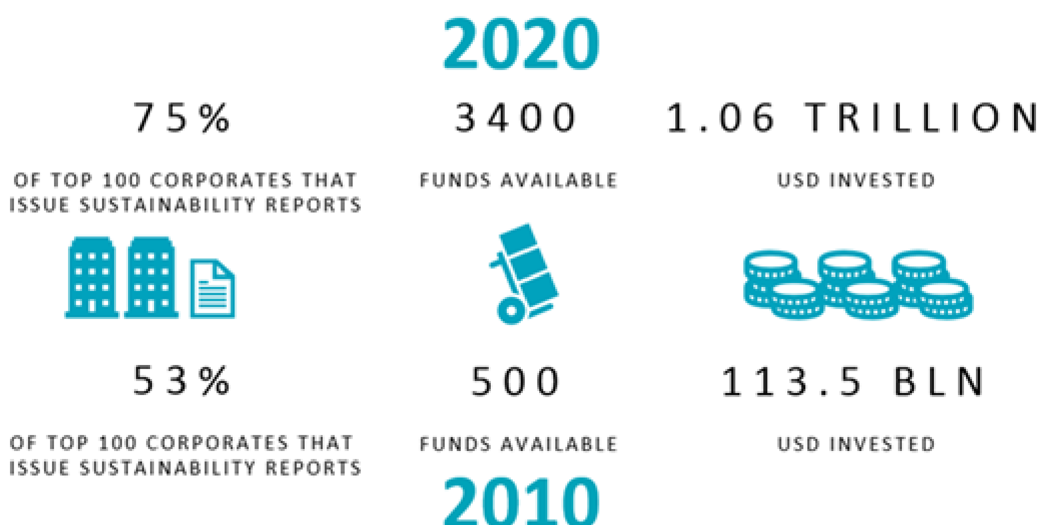
Gold Prices vs. Real Yields



Source: Bloomberg, Jupiter Asset Management/Merian

Finally, as Jan de Koning told us, the increased focus on climate change took another leap forward during the crisis and sustainability is here to stay as a core part of investing strategies. ESG factors have been an increasingly important part of our selection process and we will soon be launching specialist sustainable global equity and multi-asset funds.

Sustainable Investing 2010-2020 Changes



Source: Morningstar, Bloomberg, EY, KPMG, Swiss Sustainability Finance, Robeco

Covid 19 has delivered an exogenous shock of extraordinary magnitude. Its timing was wholly unpredictable; as Alex showed us, global pandemics on this scale are extremely rare and it is unwise to construct portfolios in anticipation of the next one, it could be generations ahead.

While the shock was enormous, it was also short. We have almost certainly been through the worst of the virus and its economic damage; indeed, the recovery we have seen to date is considerably better than earlier predictions. But the ramifications of the virus are deep, far-reaching and long lasting, with big implications for investment selection and returns.

We need to be realistic about return expectations over the next several years; global growth is recovering well but long term sustainable levels of growth are likely to be below pre-virus levels. Valuations across fixed income markets, especially safe haven government bonds, are at historic highs, and parts of the equity markets are also extended, notably the tech sectors which have dominated returns to an extraordinary degree. While these assets have important roles to play in portfolios, future returns will surely be more subdued. But there are very good opportunities in other parts of the equity market, and considerable recovery potential in the most depressed areas.

More than ever, it is important to diversify and keep a broad spread of investments, across and within asset classes, with a blend of fixed income sectors and equity styles. And while not today's problem, some protection from the possibility of a pick-up in inflation, in the form of inflation linked bonds and precious metals, is an important part of building resilience in portfolios.

My message then is stay invested; with true diversification and assets invested with some of the very best fund managers from around the world you will be well positioned to ride out this storm and participate in the more benign conditions ahead. We will defeat this virus, we are well on the way to doing so, and I am confident that next year we will be holding this event in more convivial surroundings where we can socialise and network in the traditional way.

In the meantime, and most importantly, stay safe and stay invested.

Glyn Owen
23 September 2020