momentum

harmony portfolios

HARMONY PORTFOLIOS

MULTI-MANAGER, DIVERSIFIED SOLUTIONS

Q3 ENDED 30 SEPTEMBER 2020

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Markets continued to rally in the third quarter, with global equities adding 7.9% in US dollar terms to take them into positive territory for the year, while emerging markets gained 9.6%. This follows even stronger gains in the previous quarter; one of the sharpest and fastest market crashes of all time has been followed by one of the fastest recoveries on record.

US, Asian and emerging equity markets led global markets over the quarter and outpaced their respective bond markets. Equities lagged in continental Europe though and even fell in the UK, where the market ended the quarter down by 4.6%. This underperformance was at least in part driven by local currency strength with both Sterling and the euro gaining over 4% versus the US dollar over the quarter.

Global bonds also posted positive returns, up 2.5% over the quarter and 6.1% year to date, although returns in Q3 were driven primarily by corporate credit and currency appreciation relative to the US dollar. Gold continued to perform well, gaining 5.9% over the quarter.

Markets pulled back towards the end of the quarter, with global equities declining 3.5% in September, but equities have re-joined their upward path as at the time of writing, seemingly in anticipation of a Democrat win in the US elections, which therefore increases the chances of a large additional fiscal package.

Against this backdrop the Harmony Portfolios enjoyed a strong third quarter, delivering net returns of between 1.0% and 5.5% (share class A) in base currency terms. The pattern of returns across the different Portfolios within the range was consistent with returns for the respective local markets, with the US dollar and Asian funds outperforming. Although the Sterling funds posted the smallest gains in absolute terms, they outperformed the UK equity market by over 5%. Growth risk profiles generally outperformed due to their greater equity market exposure.

The Portfolios have returned between 17% to 36% from their lows in March, driven by the sharp rebound in equity and credit markets. The MSCI World index is up 45% in local currency terms over the same period, led by the US (+52%) while the UK (+17%) trails far behind. Global bonds are 9% higher by comparison.

Our growth orientated equity allocations were once again the strongest contributors to performance over the quarter. These included: Sands Emerging Markets (+18%), Jennison Global Equity (+17.7%), Wells Fargo US Equity (+12.1%) and Merian Chrysalis (+8.6%). Our convertible bond holdings, which also have a natural tilt towards higher growth businesses, continued to perform very well with our main holdings in this area nearly matching the MSCI World index return. Given the typically defensive profile of convertible bonds (relative to equities) this is a much better outcome than one would ordinarily expect.

Value orientated equity strategies delivered mixed results; on average, the style underperformed in large part due to weaker returns from sectors such as financials and energy stocks and lower exposure to technology, but several of our managers bucked the trend through a combination of atypical sector allocations and strong performance from their higher conviction holdings. These included Lyrical in the US Dollar Portfolios, who gained 9.0%, Magallanes in the Europe Portfolio, who returned +7.4%, as well as the Contrarius strategy which is held via the Momentum Global Equity Fund and was up 14.3%.

Corporate credit exposure contributed to performance, led by the aforementioned convertible bond holdings but various other holdings delivered moderate gains. TwentyFour Income Fund (+4.5%) and Artemis Short Duration High Yield (+3.5%) were best of the rest, while hard currency emerging market bonds gained 2-3% across various holdings and the Sequoia Economic Infrastructure Fund added 1.9%.

Our strategic allocations to listed real assets (property and infrastructure) continued to lag general equity markets and so held returns back somewhat; global real estate and global infrastructure strategies delivered modest gains over the period while the combination of our UK property holdings declined slightly.

Portfolio Changes

Having reduced equity allocations somewhat over the prior quarter, replacing some of the exposure with greater allocations to convertible bonds, during this latest three-month period we kept total target equity weights unchanged across the Portfolios. We continue to hold put options on the US equity market, which provides a hedge against the risk of a shorter-term reversal in markets. After initially purchasing these in May, we decided to restrike the options in July closer to the prevailing index level having seen the market continue to move higher. We did similarly in August, also extending the maturity of the options out to November, beyond the US presidential election. These will provide the Portfolios with a degree of protection if the US stock market is at a lower level upon maturity of the option, compared to when we initiated it.

In August we rotated exposure away from nominal US government bonds to US inflation linked bonds, or TIPS. The total interest rate risk of the Portfolios was largely unchanged from these reallocations, but we now take the majority of our developed markets sovereign duration from US real rates. We see little value in traditional government bonds today and whilst near term inflation risks look limited, over 5 to 10 years we take a more constructive view, with extensive central bank support this year making inflation more of a concern down the line.

During August we also reduced the Portfolio's allocations to corporate bonds and emerging market bonds. Yields in these asset classes have fallen significantly since their peaks earlier in the year, resulting in higher bond prices and capital gains for the portfolio. Portfolio returns benefited from our decision during the second quarter to maintain and selectively increase exposure to these areas. While we still see good relative value there the opportunities are less compelling and thus warrant lower allocations. As a result of these changes, the Portfolio's cash level has increased.

Looking Forward

While the shock from COVID-19 was enormous, it was also short. Although tighter restrictions are being reintroduced in much of Europe and some parts of the US, we have probably 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 the pre-virus levels.

Markets are rightly looking further ahead and to some extent discounting an economic and earnings recovery in the coming years. However, while equity markets have come back a long way since bottoming in March, they have been driven by a small number of large technology companies. If you strip out the FANG stocks (Facebook, Amazon, Netflix and Google/Alphabet), the rest of the US market is down approximately 10% year to date and most other major markets, with the exception of China and Japan, are currently sitting on similar losses.

Periods of dislocation create high levels of mispricing and present opportunities to multi-asset investors like us and the specialist managers we allocate to. As markets have rebounded since late March many multi-asset strategies have exceeded expectations, particularly those which were invested for the long term and didn't cut risk at that point of most pain. We believe this outperformance can continue as many parts of markets – particularly value stocks along with listed property and infrastructure – remain at depressed levels and are paying investors handsomely as providers of capital whilst they wait for a recovery. Many offer yields in the mid to high single digits, compared to near zero for most high growth stocks and government bonds.

Although markets are supported by huge central bank liquidity and the prospect of a big recovery in economies in coming months, some caution is warranted. The US election, along with Europe's nascent second wave of the virus, Brexit and the rich valuations of the aforementioned large technology names, present potential short term headwinds for markets, but risks abound and it's the ones that catch investors by surprise that we should worry about most. At a time when explicit portfolio insurance – in the form of traditional defensive assets or options strategies – is relatively expensive, genuine diversification, both across and within asset classes, should be ever more appealing.

In the face of these short-term uncertainties, markets could well experience higher levels of volatility in the weeks ahead. However, 2021 promises to be a year of strong recovery, and risk assets will have continuing support from ultra-loose monetary policy as well as additional fiscal stimulus across much of the developed world. Furthermore, markets are still not discounting the roll-out of a vaccine; any good news on this front would be a major boost to confidence and sentiment and might well herald a period of significant outperformance by value stocks over growth. We therefore expect markets to move higher through 2021 and would use any setbacks in the months ahead as a buying opportunity.

Market commentary - Q3 2020

Despite a sharp setback during September, risk assets made further gains in the third quarter, building on the recovery which began in late March. Wall Street, particularly tech stocks and other clear beneficiaries of the pandemic, again led the way, with the S&P 500 returning 8.8% and the tech-heavy Nasdaq index up over 12%. Chinese markets also performed strongly, the CSI 300 index up 10%, and this, together with a weak dollar, helped push emerging markets to a return of 9.6%, outpacing the MSCI index of developed markets, up 7.9%. European markets were weighed down by increasing concerns about a damaging second wave of coronavirus and rising anxiety about the Brexit discussions ahead of key deadlines in October; Europe ex UK returned only 1.4% in euro terms while the UK market fell 4.3% in GBP terms. The underperformance of the UK, which has also been held back by the dominance in the index of energy and financials, sectors which have been severely damaged by the impact of the pandemic, has been stark: so far this year the market is down 21% compared with a rise in the US of 5%.

Increased risk appetite was reflected in fixed income markets; US Treasuries were flat, and the 2.5% return from the JPMorgan global government bond index came mainly from dollar weakness - the euro was up 4.3%, sterling +4.2% and yen +2.4%. Credit, on the other hand, performed well, notably high yield bonds +4.6%. A rise in inflation expectations from the extremely low levels seen in March supported US inflation protected bonds, +3.2%, as well as gold, +5.9%, which remains one of the best performing assets so far this year, +24%. Driving markets were two key factors. First was the continuing economic recovery from the pandemic induced collapse in the early months of the year. This has been sharper than many predicted and has in turn resulted in corporate profits generally coming in ahead of expectations, although clearly not across all sectors. Second was the extraordinary support provided by the major central banks, which continue to purchase assets on a substantial scale while keeping interest rates close to or below zero, and provide guidance which points to a long period ahead of ultra-loose policy.

Foremost in this respect was the Fed and its review of the longer term goals of monetary policy, pointing to loose policy until it achieves its new target of inflation averaging 2% over time and longer term inflation expectations anchored at 2%. This provides the Fed with ample room to allow the economy to run hot for a period following years of sub 2% inflation. Combined with the signal that rates would remain near zero through 2023, while keeping QE, or asset purchases, at the current rate, investors have been provided with the near certainty of almost zero rates and substantial liquidity injections from the world's pre-eminent central bank for years ahead. Developments on fiscal support programmes were more mixed. As the human cost of the pandemic continued to spread across the world, with extended first waves in parts of the US and in many developing countries, most notably Brazil and India, and rapidly developing second waves in Europe, the need for sustained and substantial fiscal support became increasingly urgent. But the longer term costs of such support presents tough choices for governments. The much-hailed EU Recovery Fund announced in July will not begin to distribute funds until next year and is already meeting some resistance from member states, leaving individual governments to extend fiscal packages to avoid the potential cliff edge as the furlough and similar earlier schemes end. In the US there is still no agreement between the President and Congress on the fiscal stimulus package deemed necessary following the expiry of earlier support programmes. Figures of up to $2tn, amounting to 10% of GDP, are under negotiation but are held up by political wrangling, compounded by the looming election.

Markets have been sensitive to these developments given the increasing urgency for additional support to prevent long term scarring and a slide into a sustained economic slump, but the issue in the US, and elsewhere across the developed world, is not whether further support should be forthcoming, but its size and composition. Nowhere are there serious suggestions of a return to post-GFC type fiscal austerity.

While there had never been realistic expectations of a vaccine before covid second waves emerged, developments have been encouraging, with 7 vaccines now in stage 3 clinical trials. The front-runner appears to be the Oxford-Astra Zeneca drug, which can be produced cheaply in vast quantities and could be rolled out in a matter of months. This possibility, albeit with its attendant uncertainties, is not fully discounted in markets and would be a game-changer in terms of economic behaviour and investment opportunity.

With the economic fall-out from the pandemic persisting and probably deepening in the weeks ahead as second waves engulf Europe and elsewhere during the northern hemisphere winter, markets face a more challenging period ahead after the generally benign conditions of the past 6 months. The economic recovery underway could be stalled and longer term scarring is a real threat to growth. Additional uncertainty surrounds the US Presidential election; investor concern is less about who wins (although Biden is likely to be less market friendly because of his high tax, high spending instincts), and more about what happens if the result is disputed. This might well result in bouts of volatility in markets, but should be resolved in a relatively short period of time – the constitution and rule of law will prevail.

The other immediate concern for markets is the EU-UK Brexit negotiation; as we approach critical deadlines ahead of the end of the transition period there are fears that a deal will not be struck, leaving the UK to trade with the EU on WTO terms from 1st January 2021. Since this is plainly in neither side's interests the political pressures to compromise over the few remaining outstanding issues will intensify, and the most likely outcome appears to be an 11th hour deal in classic EU style. In the meantime, however, the uncertainty adds to investor unease.

In the face of these short term uncertainties, markets could well experience higher levels of volatility in the weeks ahead. However, 2021 promises to be a year of strong recovery, and risk assets will have continuing support from ultra-loose monetary policy as well as additional fiscal stimulus across much of the developed world. Furthermore, markets are still not discounting the roll-out of a vaccine; any good news on this front would be a major boost to confidence and sentiment and might well herald a period of significant outperformance by value stocks over growth. We therefore expect markets to move higher through 2021 and would use setbacks in the months ahead as a buying opportunity.

For more information, please contact

Anastasiya Volodina
Distribution Services
e: harmony@momentum.co.uk
t: +44 (0)207 618 1806
www.harmonyportfolios.com

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