2020 Global Investment Outlook

3rd Quarter Insights

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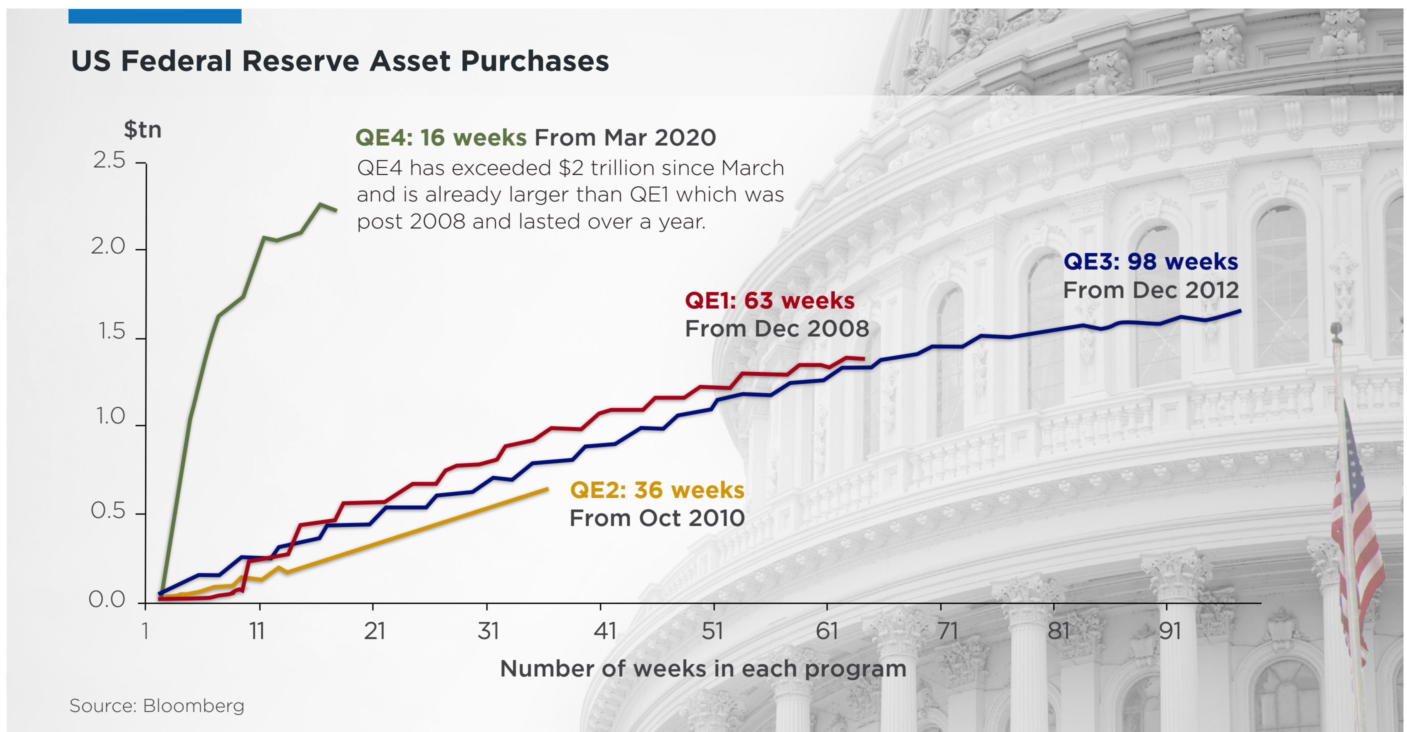
After the historic falls in markets in February and March, markets have responded to the extraordinary amounts of stimulus from central banks and governments.

Central Bank Action

This quarter saw some of the worst economic data on record and at the same time, markets rallied powerfully. The nadir of the economic output was during the month of April as large swathes of the global economy were in forced shutdown.

The US unemployment rate rose to nearly 15% whilst over 40 million workers in Europe and the UK were supported by government furlough schemes. As is often the case, the equity market rallied ahead of any recovery, anticipating the upswing, even as the news flow was dire.

The asset purchase programmes of central banks have been extraordinary their size, speed and breadth. The Federal Reserve's latest quantitative easing programme (QE4) has exceeded $2 trillion since March and is already larger than QE1 which it initiated in the aftermath of the financial crisis and lasted over a year. It also includes investment grade bonds and, for the first time, those bonds which have been downgraded to high yield, providing significant support to credit markets. It has allowed companies to issue over $1 trillion of corporate bonds to support their businesses through the global recession. These policies have provided a bridge to economies during the lockdown period.



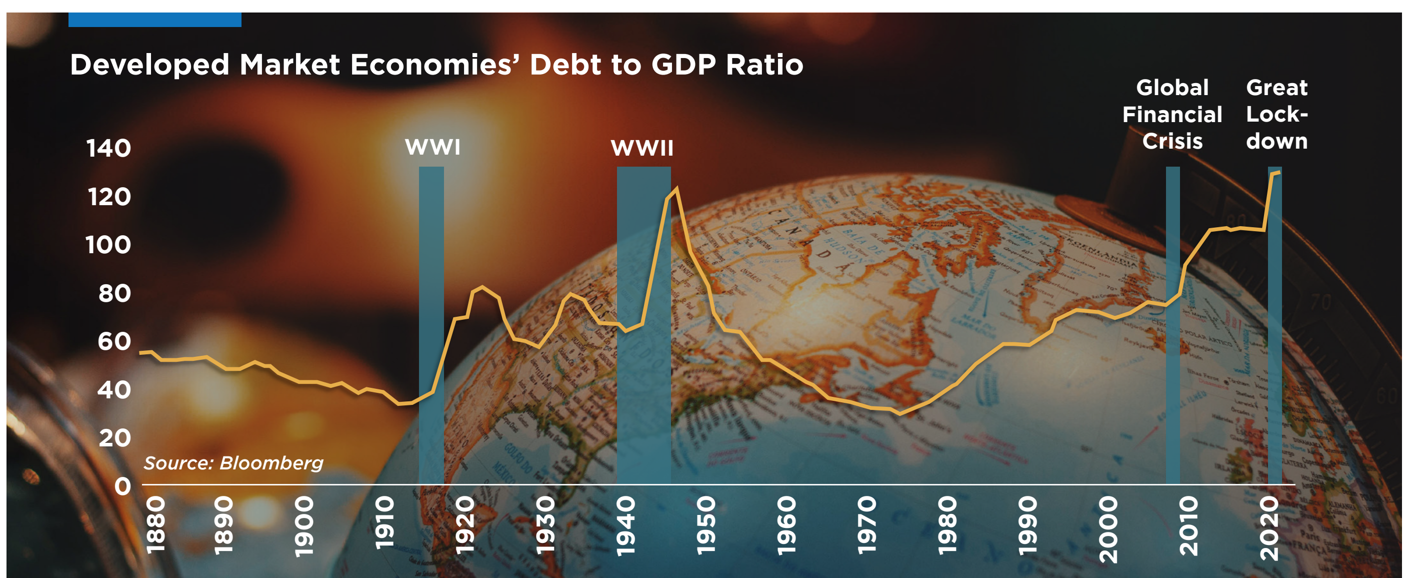
The world is now moving tentatively into the next phase, re-opening economies as the immediate threat of the virus has fallen in most countries although some emerging countries are still seeing a rapid increase in numbers, while in the US several states are continuing to see a sharp pick up in infection rates. After the shocking jobs numbers in March and April, unemployment levels are starting to fall as people return to work. Forward looking economic data has also started to improve although economic activity is still some way below the levels prior to the outbreak of COVID-19.

One natural concern for investors is: what happens if central banks stop supporting markets and start to withdraw liquidity? Could we see government bond yields spike, pushing down prices in fixed income markets? In the short term, central banks have given crystal clear signals that interest rates won't be going up for several years. The Federal Reserve's committee members provide their guidance for future interest rates to the end of 2022. There is usually some disagreement about the future path of interest rates. Not today. They are almost unanimous in their view that interest rates will be kept at current levels over that period, driven by their dual mandate of stable prices and maximum sustainable employment. They expect that inflation will be below target whilst unemployment will be too high over this period necessitating ultra-low interest rates.

What if the central banks are wrong about either (or both) of these?

They have been wrong before. Would a pickup in inflation force them to raise rates? The Federal Reserve has been debating this issue and how they would deal with the threat of rising bond yields choking off the recovery. One tool they have been considering is yield curve control, something that has been in place in Japan since 2016 and the Reserve Bank of Australia adopted in March of this year. The central bank effectively decides what level they want bond yields to be and buy enough bonds to get them there, whenever yields rise. Market participants soon get the point that central banks are the biggest bully in the playground and stop betting against them. We think that it is possible that other central banks will employ this policy, should they need to do so.

Governments find themselves with uncomfortably high debt levels after providing support to individuals and corporates during the coronavirus crisis. The IMF forecasts that developed economies debt to GDP may reach 131% by the end of the year, exceeding the peaks in the aftermath of the second world war. There are four ways to reduce this debt pile and none of them are particularly appealing: austerity, higher taxes, default or by eroding the value of the debt relative to the economy. Austerity was wildly unpopular in the last decade and governments have signalled that there will be more, not less fiscal spending to boost growth. Outright default is highly unlikely but writing off debt held by central banks is not unthinkable. Most likely, we will see both higher taxes and attempts to erode the value of debt after inflation. Holding down interest rates even as inflation picks up is a tried and tested system to make this happen, known in the aftermath of the war as financial repression.



How does one protect against this? Sadly, savers with cash in the bank will be punished with meagre returns that fail to protect against the corrosive impact of inflation. We continue to invest in asset classes that demonstrate real long term returns after inflation across Equities, Fixed Income, Diversifying Assets and Alternatives. One asset class that has a long history of protecting investors from the ravages of inflation is gold. When cash rates are lower than inflation, gold has an enviable record of preserving value. We think this will continue to be the case for some time.

Conclusion

Markets have rallied from their lows in the middle of March thanks to the prompt and forceful response from central banks. Considerable uncertainty remains, with risks of further outbreaks but also hope that one of the many vaccines being developed successfully passes through clinical trials. Governments have provided support for consumers and business as they emerge from the enforced lockdown. Now that the door has been slammed shut on the austerity era, the strength of the recovery will be influenced by how bold governments are in boosting spending to drive the recovery. Given the wide range of outcomes from this highly uncertain environment, we believe that a diversified portfolio is the right approach.

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