Butterfield

Investment Review

3rd Quarter 2020

Summary of markets and outlook

The Winding Road to Recovery

Against a backdrop of a global economy that continues to recover from the depths of the crisis in the second quarter, financial markets spent the third quarter of 2020 grappling with the contrasting forces of better economic data, together with rising virus cases in Europe and fading policy support. An extraordinary level of policy support has helped many households and businesses weather this period of depressed activity, but the benefits have not been evenly distributed, as this crisis has hit some sectors of the economy much harder than others. While those sectors most exposed to social distancing measures, such as travel, restaurants and entertainment have seen an unprecedented level of disruption, some of the largest companies in the world (and therefore largest constituents of stock market indices) have been beneficiaries of profound shifts in demand. This dynamic helps to explain the apparent disconnect between the strength seen in financial markets and the weakness in the real economy.

Technology has been a common theme running through many of these beneficiaries, as it has played an important role enabling people to work remotely, or have goods delivered directly from companies with the necessary e-commerce platforms and/or delivery infrastructure. Another area which has performed very well has been the housing market. The US housing market is at its most buoyant since 2006, and has been boosted by ultra-low mortgage rates together with people moving to larger properties or out of shared accommodation. On both sides of the pond, this trend also extended to home improvements, as many people took the opportunity of spending an increased amount of time at home to do some construction or replace home furnishings.

These large shifts under the surface have made analysis of the overall state of the economy challenging. For example, if a household cancels a planned $3,000 holiday and instead spends $1,000 on a new laptop computer and $2,000 on home improvements, overall spending is unchanged, but the composition of the spending is very different. Such a shift may sound benign, but it can have significant second-order effects. To continue the example, if the laptop manufacturer and home improvement store can meet this demand with their existing labour force, but many people in the tourism industry lose their jobs, then this will be an overall net negative impact on the global economy. This divergent company performance is something that we have seen strongly reflected in financial markets; airline stocks have remained in the doldrums, but stocks like Apple, Lowes and Kingfisher have performed very well.

Broadly speaking, it appears that COVID-19 is going to be with us for longer than many initially thought, but at the same time, large parts of the economy appear to be more resilient than many analysts expected. Financial markets are famous for “looking forward” and it is the future that matters, not the past. Government support programmes have been very effective at filling the gap of lost incomes, however this support is now starting to wane. For example, under the Cares Act passed in March, US airlines received $25 billion in aid with the stipulation that carriers couldn’t lay off or furlough any workers before 1 October. With airline travel still well below last year’s level, it is important

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that further support arrives. As of the first week of October, there is an airline-specific bill which House Speaker Nancy Pelosi has described as an "initiative… focused solely on the workers, keeping them on the payroll so these workers maintain their critical training and certification requirements unique to their industry," but it has not yet been passed. This is just one example, but challenges such as this continue to be felt in many sectors and the path back to normality isn't a simple one. However, the world is getting better at managing the impact of the virus, and as long as there are no policy mistakes the global economy should continue to heal.

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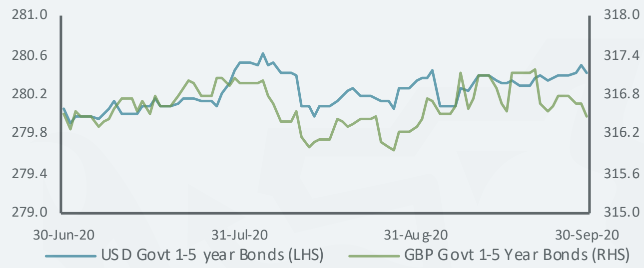

Fixed Income

In contrast to the volatility in equity markets, fixed income markets were relatively subdued in the third quarter. The two-year treasury yield remained pinned at a very low level of 0.13% and despite the economic recovery, the 10-year treasury yield only managed to rise a few basis points to 0.69%. Inflation protected bonds, investment grade, high yield and emerging market debt all managed to outperform government bonds. In contrast to the sharp snapback in economic activity after the low point in April, the pace of the recovery has slowed, as more consumer-sensitive sectors such as travel and tourism, remain in hibernation. Fixed income markets currently await the outcome of three key events, all of which should provide clarity in the fourth quarter. Firstly, as we enter winter in the Northern Hemisphere, will COVID-19 reestablish itself? Secondly, can the EU/UK come to an agreement on Brexit? And finally what will be the outcome of the US election? Even though we do not know the outcome of any of these events at this stage, we are optimistic. Simply put, these events will pass soon and we can move on; a degree of certainty will return to the world - especially on the trade front - and this is good for risk assets.

US economic data has continued to perform better than expected, with the unemployment rate now almost below 8%, but as described above, the recovery remains split with huge segments – predominately lower earning service workers – still in recession. The Federal Reserve has been largely absent since May and has allowed their balance sheet to shrink back below US$7 trillion. Financial markets are functioning normally and borrowing costs are low, hence the next round of stimulus needs to come from the US Treasury, preferably targeting the lagging areas of the economy. In Europe, the recent uptick in COVID-19 cases has stopped the recovery in its tracks, but social support programmes are generous, which provides a floor in demand in the short term. The UK continues to muddle through, with Brexit negotiations likely to come down to the wire in coming months and currently, at the Bank of England and ECB, monetary support is almost open ended and unlikely to be dialed back anytime soon.

Financial market gyrations in the coming months will likely be dominated by the US election outcome. At the end of the quarter, betting markets and polls gave Joe Biden an approximate +20% lead over Donald Trump. This partly reflects the perceived poor performance of Trump at the first presidential debate, but the trend was already in place beforehand. However, a month is a long time in politics and given the outcome of 2020 so far, literally anything could happen. While we wait for the official vote, we can attempt to analyse the impact of each candidate's policies and their impact on fixed income assets. A clean sweep by the Democrats will almost certainly lead to higher corporate and personal taxes, higher regulation and massive fiscal stimulus. Taken together, this should lead to a much steeper yield curve and with the Federal Reserve anchoring base rates, this impact will be seen mostly at the long end of the curve. The US dollar will likely also continue its gradual decline as the monetary base increases and global growth recovers. Interestingly, the re-election of Donald Trump is likely to affect markets in a very similar, but less extreme way, as fiscal stimulus will be much more constrained. However, reduced uncertainty and a more stable Biden administration will likely give a further boost to risk assets and nominal bond yields.

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COVID-19 continues to dominate, with global cases officially reaching 34 million, but in reality the number is likely much higher due to inadequate testing at the start of the year. The caution we exhibited towards the end of the second quarter due to rising US cases was in hindsight unwarranted. While case numbers rose rapidly during July, hospitals were never close to capacity and fatalities were much lower than those witnessed in New York during March/April. As a result, risk assets remained resilient. Bond yields did drift lower, but this was driven by the expectation that base rates will be on hold for a much longer period. Therefore real yields declined further as inflation expectations increased to pre-COVID levels. This slightly more optimistic backdrop gave way in September as Europe, with mobility boosted by schools returning, registered its second wave, triggering local lockdowns and movement restrictions, although at the time of writing, fatalities are much lower than earlier in the year; much like the US over the summer.

Portfolio positioning remains largely “risk on” with a continued preference for investment grade corporate bonds, inflation protection, emerging market debt and US high yield debt exposure, but we are well aware that current valuations leave little room for error. Hence we have opted to raise cash levels (where appropriate) in order to mitigate against near-term volatility. Why not just add US Treasuries? As we mentioned above, the long end of the curve is extremely vulnerable depending on who leads the US next year, and to compound this, a COVID-19 vaccine is likely to be rolled out in 2021, which would unleash pent up consumer and corporate spending. This would result in higher bond yields and capital losses for investors; one of the main reasons we remain underweight duration for longer accounts, even though we are faced with a mountain of uncertainty. The low level of government bond yields also leaves little value as a hedge if another volatility event happens in markets. Therefore an exposure to cash is valuable on a risk-adjusted basis.

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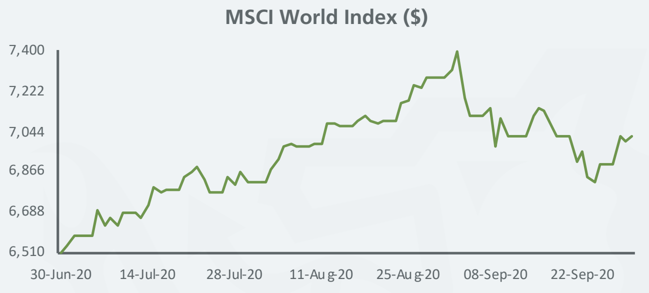

Equities

Despite a pull back from all-time highs (in some markets) in September, equity markets finished markedly higher for a second consecutive quarter. The MSCI World index returned 7.9% in US dollar terms for the third quarter, following a strong second quarter recovery from the March lows. Global equities are now mildly positive on a year-to-date basis, returning 1.7% in dollar terms, and are meaningfully higher over the past 12 months, returning 10.4%. As has been the case for much of the year, the Technology and Consumer Discretionary sectors performed well, while the interest rate sensitive sectors underperformed. A cyclical recovery and rotation of sorts occurred in the quarter; however the pace of recovery has been – and will continue to be – extremely bumpy across, and even within, sectors.

Shares of cyclically exposed Industrials and Materials companies appreciated 11.7% during the quarter signaling improving investor appetite for pockets of the market that have been hurt most by a lack of mobility and shifting consumer behaviour. Within the Industrials sector, Transportation-based companies performed well during the quarter as consumers relied on eCommerce delivery. The strength in Transportation did not translate to the Aerospace sub-sector, which actually fell during the quarter due to lower levels of air travel demand, as well as continued idiosyncratic issues at Boeing. There are countless examples of winners and losers outside of the Industrial sector; however, we think this diverging performance is indicative of how the recovery will unfold over the coming months and years.

The energy transition away from fossil fuels towards cleaner forms of energy is an increasingly important topic in equity markets. In terms of performance, the energy sector continues to see some significant underperformance, falling by more than -40% over the past 12 months and underperforming the MSCI World by over 50% over that same time period. 10 years ago the Energy sector comprised 10% of global equity market capitalisation, as Exxon Mobil was the largest company in the world. Fast forward to 2020, the Energy sector comprises only 3% of global equity market capitalisation, and Exxon has fallen outside the largest 50 global companies. Major industry players have very recently begun to develop plans to transition from strictly integrated oil operations to develop, produce, and distribute cleaner forms of energy. BP has recently released a long-term plan to transform the company, with the ultimate goal of being net-zero emitter by 2050, and has also begun investing in offshore wind power as a sign of their commitment. BP is certainly not alone, and we continue to favour those companies that are investing and developing cleaner forms of energy for those clients that have exposure to the sector.

The equity market wasted no time in pricing in a more positive outlook as the economy has recovered, but this does mean that valuations are stretched relative to their long-term averages. However, the very low level of bond yields and corporate borrowing costs, help to underpin these valuations and company earnings have been much more resilient. Further virus cases and the US election are risks as we move forward, but we continue to spend our time trying to understand what the post-COVID world will look like, and which sectors and companies will be best placed to benefit.

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Quarterly statistics

Equity Indices	3 Month % Change 30 Jun 20 to 30 Sep 20	6 Month % Change 31 Mar 20 to 30 Sep 20	9 Month % Change 31 Dec 19 to 30 Sep 20	12 Month % Change 30 Sep 19 to 30 Sep 20
Global				
MSCI World Index	+7.93	+28.82	+1.70	+10.41
MSCI World Index (Sterling)	+3.48	+23.70	+4.48	+5.10
MSCI World Index (Euro)	+3.52	+20.57	-2.57	+2.69
MSCI Emerging Markets Index	+9.56	+29.37	-1.16	+10.54
United States				
Dow Jones Industrial Average	+8.22	+28.25	-0.91	+5.70
S & P 500 Index	+8.79	+30.95	+5.13	+14.49
NASDAQ Composite Index	+11.24	+45.66	+25.33	+40.96
Europe				
Continental Europe - Dow Jones Euro Stoxx 50	-0.83	+16.39	-13.11	-8.63
France - CAC Index	-2.03	+11.18	-17.90	-13.41
Germany - DAX Index	+3.65	+28.43	-3.69	+2.68
Switzerland - SMI Index	+1.49	+11.38	-0.84	+4.46
UK - FTSE 100 Index	-4.02	+4.76	-20.21	-18.07
Far East				
Asia - MSCI Asia Pacific Index (US Dollars)	+8.57	+25.87	+1.60	+11.21
China - Shanghai Composite	+7.82	+17.01	+5.51	+10.77
Hong Kong - Hang Seng Index	-2.72	+1.79	-14.37	-7.22
Japan - Nikkei 225 Index	+4.69	+23.50	-0.24	+8.67
MSCI World Sectors				
Consumer Discretionary	+15.99	+50.65	+17.58	+25.60
Consumer Staples	+7.53	+16.85	+1.30	+3.91
Energy	-15.96	-2.05	-45.92	-43.22
Financials	+1.80	+14.93	-21.64	-14.77
Healthcare	+4.78	+20.03	+6.26	+20.81
Industrials	+11.69	+31.10	-3.16	+3.97
Information Technology	+11.82	+46.66	+27.36	+45.16
Materials	+11.73	+40.65	+3.59	+12.55
Real Estate	+2.12	+14.02	-12.54	-11.52
Communication Services	+8.31	+28.91	+6.39	+14.80
Utilities	+4.74	+11.26	-4.13	-2.16

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Bond Indices				
Bloomberg Barclays Series-E US Govt 1-5 Yr Bond Index	+0.13	+0.53	+4.37	+4.72
Bloomberg Barclays Series-E UK Govt 1-5 Yr Bond Index	-0.02	+0.64	+1.81	+1.20
Bloomberg Barclays Series-E Canada Govt 1-5 Yr Bond Index	+0.18	+0.84	+3.98	+3.88
Bloomberg Barclays Series-E Euro Govt 1-5 Yr Bond Index	+0.28	+0.73	+0.40	-0.27
Foreign Exchange Rates				
Sterling versus US Dollar	+4.30	+4.14	-2.65	+5.05
Sterling versus Euro	+0.04	-2.54	-6.76	-2.29
Sterling versus Swiss Franc	+1.47	-0.66	-7.20	-3.00
Sterling versus Canadian Dollar	+1.96	-2.28	-0.16	+5.60
Sterling versus Japanese Yen	+2.07	+1.97	-5.40	+2.51
US Dollar versus Euro	-4.26	-6.85	-4.39	-7.51
US Dollar versus Swiss Franc	-2.71	-4.61	-4.66	-7.67
US Dollar versus Canadian Dollar	-2.24	-6.17	+2.57	+0.53
US Dollar versus Japanese Yen	-2.13	-2.09	-2.81	-2.42
Trade Weighted US Dollar Index	-2.91	-4.46	+2.29	-0.54
Commodities				
Reuters/Jefferies CRB Commodity Price Index	+7.64	+21.94	-20.07	-14.62
Gold Spot $/Oz	+5.89	+19.67	+24.29	+28.07
Silver Spot $/Oz	+27.63	+66.39	+30.37	+36.73
Brent Crude Index (London)	+27.69	-10.66	-34.05	-25.33
Crude Oil Futures (New York)	+2.42	+96.39	-34.13	-25.61

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