GLOBAL EQUITY
INVESTMENT OUTLOOK

SARASIN
& PARTNERS

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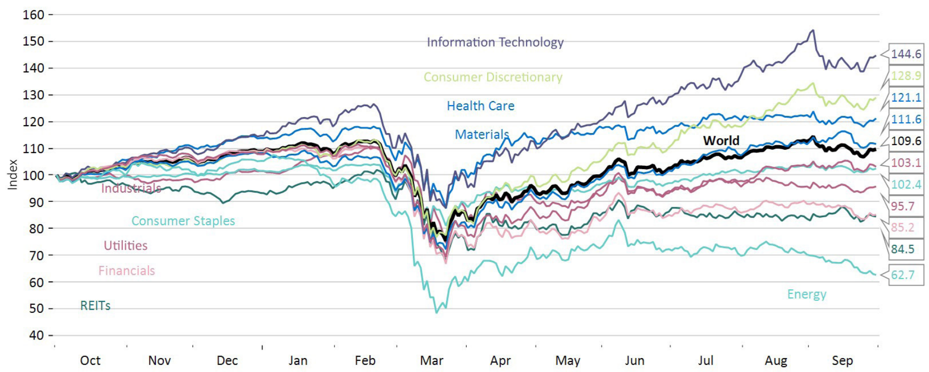
- ## KEEPING DIVERSIFIED IN A NARROW MARKET
- ## MORE POLICY, LEVELLING-UP AND WARMING-UP
- ## 'DOWNSIZE & DISTRIBUTE' TO 'RETAIN & REINVEST'

FIGURE 1 MSCI ACWI SECTORS, TOTAL RETURN GBP LAST 12 MONTHS

Source: Macrobond, October 2020



The global equity index continued its rally in the third quarter, but by half way through the period, momentum was faltering. Despite the rebound at the index level, at the sector and stock level the market is not yet factoring in much of a post-pandemic recovery. What we have seen since the market troughed in March is an enormous premium placed on earnings certainty and current revenue growth, propelling a substantial re-rating of stocks such as Apple (PE moved from 16x to 30x) and Microsoft (EV/EBITDA from 14x to 20x). Meanwhile JP Morgan is stuck at 1.3x book value and Legal & General has a 9% dividend yield.

The portfolio outperformance this quarter was again led by a handful of technology stocks (Alibaba, Taiwan Semiconductor and Facebook) and also at-home consumption (UPS and Home Depot). The continued narrow obsession of the market with technology and internet retail suggests we should have put greater emphasis on these themes. However, in expectation that the market will move on, we have maintained a significant weighting to cyclical stocks, some of which have bucked the trend and also performed exceptionally well. Agricultural equipment manufacturer John Deere, elevator company Otis, industrial equipment supplier Schneider Electric and Daikin air conditioning all performed well in the quarter.

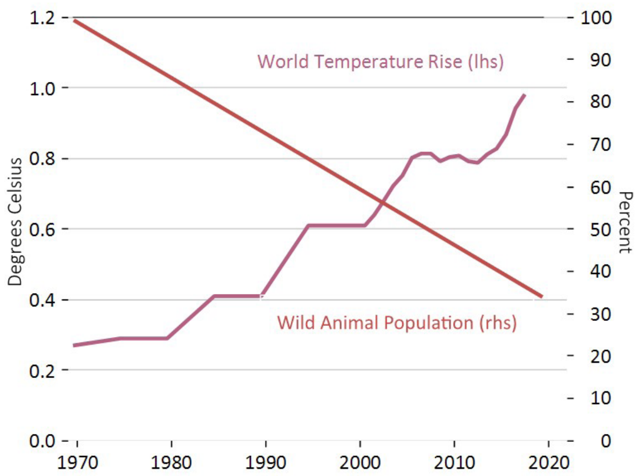
We took some profits in the latter two (both beneficiaries of accelerating climate change related spending) but maintained the cyclical exposure, adding to packaging company DS Smith, as well as to JP Morgan and a little to Marriott.

The economic scarring from the Covid pandemic (CV-19), in the form of unemployment, consumer caution and demand loss, will be long-lasting and the accelerating forces of disruption will have profound impacts on historic patterns of corporate profits. Many dividends have been cut and share buybacks reduced; balance sheets are damaged, requiring gradual repair. Nevertheless, the next phase will likely see some broadening-out of the market if a gradual reopening of the global economy leads to improved business and consumer confidence. And this in turn is somewhat dependent on a clean US election, continued fiscal support and a vaccine (or greater acceptance of the health risks of allowing the virus to spread amongst the less vulnerable). We can debate the political outcomes or the probability and timing of vaccine trial success - our insight here is limited. However, with US 10-year government bond yields at 0.67% we might argue that economic reflation is not priced into markets.

Generating a sustainable recovery will require continuing policy intervention on a massive scale. With interest rates already close to zero, the extraordinary

FIGURE 1 WORLD TEMPERATURE RISE AND WILD ANIMAL POPULATION DECLINE

Source: Macrobond, October 2020



As well as social imbalance, nature is dangerously out of kilter...

economic shock is pushing economic policy into uncharted territory. Central banks will continue with extreme financial repression measures to prevent deflation – a much greater evil than allowing inflation to exceed their 2% targets. But the strongest economic influence will be from exceptionally large government spending, funded primarily by borrowing. This has introduced 'fiscal dominance' where governments override the independence of the central banks by simply requiring them to 'monetise the debt' - to create new money to buy the newly issued government debt (advocated by some as "Modern Monetary Theory", MMT).

But tipping so much policy petrol on the fire carries risks, not least for inflation. The sheer scale of policy stimulus raises the risk of inflation picking-up, or at least the fear of inflation re-emerging. After such a large fall in economic activity in 2020, 2021 will see a rebound and the high annual growth rate off a low base may surprise some. Even a small shift in expectations could cause a sharp shift of emphasis within equity markets.

A meaningful rotation into stocks with more economic sensitivity raises the risk that the largest companies in the global indices that have led the market recovery may fall in price. This could happen because they are a) highly valued, b) capitalising revenues and profits brought forward by Covid-19, c) popular with inexperienced investors, and d) exhibiting surprisingly low levels of volatility. It is notable that when the NASDAQ Index (dominated by technology stocks) sold off in early September, it did so on declining volatility. Economic recovery would imply higher bond yields and an increased discount rate applied to long duration assets, diminishing enthusiasm for the most highly-rated growth stocks.

Without a rapid return to full employment we expect wage inflation, and wider inflation measures, to remain subdued over the medium to long-term. But we also see the risks of a shorter-term change in inflation expectations to be high, and so maintaining a diversified portfolio is prudent. Market perceptions of medium-term opportunity will broaden, leading to a reassessment of where global equity market risk and opportunity lie. Our focus is on theme and stock selection within the wider market as the narrow leadership of stocks in 2020 gives way.

MORE POLICY, POLITICS, LEVELLING-UP AND WARMING-UP

A short-term rise in inflation is not just an ongoing risk for asset prices, it creates political and policy dilemmas: if the prices of goods and services start to rise but unemployment is slow to pick up, keeping wages subdued, household incomes will be squeezed, particularly for the poorest.

CV-19 has affected the most vulnerable in society especially hard – the elderly have suffered more from the virus; unemployment has disproportionately impacted those on the lowest incomes, often lower-skilled and younger workers; developing countries have not had the resources to cope. On the other hand, policies that have driven-up asset prices have rewarded the wealthy and Wall Street more than Main Street. This 'K'-shaped recovery seems politically unsustainable. 'Levelling up' was already a concern for politicians before CV-19. The outpouring of empathy for Black Lives Matter is a powerful expression of the rising rejection of social injustice - the post pandemic era must fashion a more inclusive future than the past.

The primary political objective is now to enable people to find productive jobs. This requires preventing excessive bankruptcies and creating growth that puts employment objectives above inflation concerns and austerity. Easier said than done. A series of public infrastructure projects, financial reforms, and regulations worth trillions of dollars are planned, making government a much more dominant player in the economy.

Policies to reverse rising inequality will lead to changes in tax rates. Tax revenues have collapsed in 2020 and it is inevitable that taxes will have to rise. Increasing corporate tax rates will raise the most revenue and raising higher rate income tax bands and wealth taxes will gain the most political capital.

As well as social imbalance, nature is dangerously out of kilter. Growing public support for conservation has provided greater political opportunity to tackle climate change and biodiversity loss more aggressively, despite this requiring global cooperation and significant concessions to developing countries by developed countries. In proposed 'green new deals' climate change is being put at the centre of policy, although in many cases still more for expediency than conviction. Associated with job-creating green infrastructure investment are regulations to increase the fiscal multiplier by accelerating private sector spending. This is particularly important to achieve anything like the scale of systemic changes needed in power generation, transport and consumption. To give an idea of scale, the Intergovernmental Panel on Climate Change (IPCC) recommends $1.8 trillion is spent on energy transition each year, many times current spending even with the new deals. The potential in the climate change theme is still significantly under-estimated.

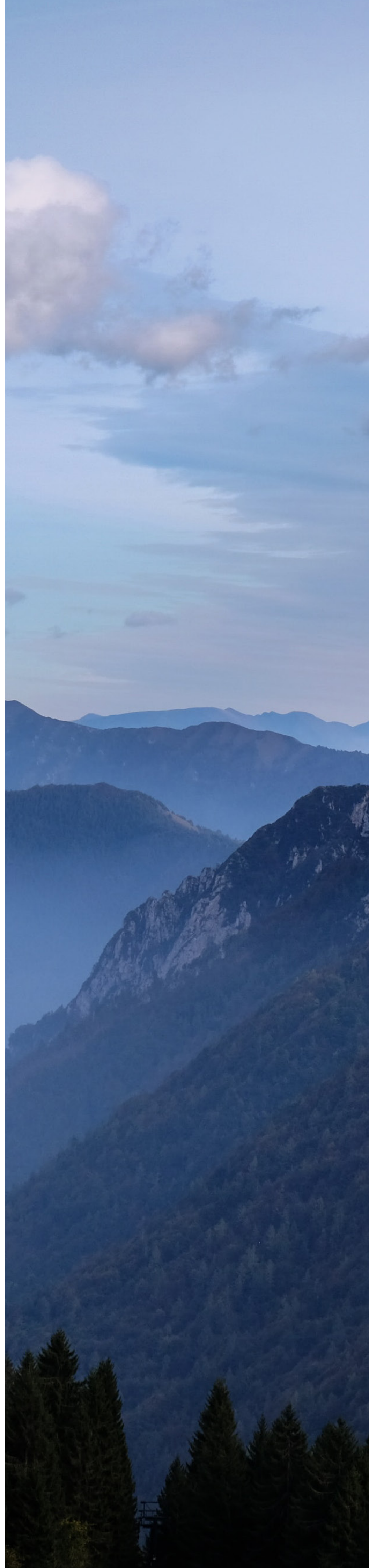
Some profound changes in thinking at a microeconomic level should be noted too, as shareholder and corporate philosophy is clearly shifting to a more utilitarian approach that balances corporate purpose and profit. The 'shareholder value maximisation' mantra popularised by Milton Friedman in 1970 is now being rejected in its purest form. Management were focused on profit with generous share-linked incentive plans. Instead, they are now encouraged to consider employees, customers, suppliers, community, and the environment in their decisions. The benefits may well include a change from a 'downsize-and-distribute' management approach that has favoured share buybacks and short-termism to more of a longer-term 'retain-and-reinvest' strategy. The long-term outcome may well be a boost to innovation, greater employment stability and less income inequality.

CONCLUSION

Looking past the pandemic, investment strategy must take account of some enormous secular influences, not least an ageing population, galloping technology, relentless climate change and an evolution in political philosophy.

We assume that CV-19 will impact the normal functioning of the global economy for the next 18 months. This is a lengthy disruption that will reshape consumption and investment. After a sharp rebound, growth will settle at trend rates lower than before CV-19, with activity driven more by government spending and regulation and less by discretionary spending.

However, in the shorter-term there is now a real risk of a shift in inflation expectations, and with it a change from the blinkered performance of equity markets. We are maintaining a diversified portfolio. Our stock selection focus is on secular growth themes and within this framework we aim to ensure a balanced exposure to include stocks with cyclical franchises.



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