ROCQ CAPITAL

Third Quarter 2020

This has been the quietest quarter of the year so far in markets, having neither the precipitous drops of Q1 nor the spectacular rallies of Q2. Nonetheless, there have been significant moves in a variety of asset classes and the high dispersion of returns between sectors and regions has continued.

Economic and corporate data have been mixed, reflecting the stop-start nature of activity in many countries and the contrast between certain sectors that have been able to grow uninterrupted and the wider challenges facing most other parts of the economy. Second quarter company earnings, released in July and August, were stronger than expected as whole, with high-profile technology companies, such as Apple and Amazon, unsurprisingly posting very good results. This helped carry markets higher in August, with US and Japanese equity indices particularly strong and other regions also positive after a mixed July. Markets then fell in September as sentiment soured due to increasing restrictions in many countries which look likely to result in a slower recovery from the global recession.

For the quarter as a whole, the MSCI World Index of global equities gained 7.5% in USD terms (+3.1% in GBP), with the US (S&P 500 +8.5% in USD, +4.0% in GBP) outpacing other developed markets thanks in large part to the preponderance of large technology companies mentioned above. By contrast, the Eurostoxx 50 of leading Eurozone companies and the UK FTSE 100 both fell during the quarter. US economic data has recovered well on a relative basis, though at the cost of a higher number of Covid-19 deaths than elsewhere.

Emerging markets were amongst the top performers, helped by the weakness of the US dollar – which makes dollar financing easier – and driven by China's recovery. The MSCI Emerging Markets Index gained 8.7% in USD (+4.3% in GBP) during the quarter. China seems to be benefiting from a 'first in, first out' effect with respect to coronavirus, with economic activity moving towards previous levels more rapidly than elsewhere and many of its leading companies able to benefit from increased use of e-commerce.

Policymakers have continued to provide stimulus and loose monetary conditions, which has helped support stock and bond markets. Leading central banks look set to keep interest rates very low for the foreseeable future, with the US Federal Reserve also shifting its mandate to allow it to keep rates down even if inflation starts to rise beyond 2%. The Bank of England has been wondering aloud about following the European Central Bank and taking rates negative. Government programmes have more of a shelf-life but, as seen in the UK towards the end of September, there is no appetite for a sudden stop to furlough and business support schemes. In July, the European Union agreed a €750bn recovery fund backed by common bond issuance by the European Commission. This is important due to its size but, perhaps more significantly, as a sign of common thinking and a step towards potential fiscal integration. Whatever one thinks of the euro as a project, it has always been hamstrung by the lack of a common tax policy and fiscal transfers between countries; as a result the recovery fund may represent a first step towards making the Eurozone a more credible currency bloc which would arguably be beneficial for European assets in the long term.

September saw the return of rancorous relations between the UK government and the European Union on the terms of the future relationship between them, with the UK seeking to redraw parts of the withdrawal agreement. This caused a modest sell-off in UK assets, capping a disappointing quarter in which both equities and gilts fell in value in contrast to many other regions.

Outlook

There is no expectation of interest rates rising in the major economies for the foreseeable future – this, along with other forms of liquidity provision, makes for a supportive environment for risk assets such as equities and corporate bonds. We have already seen this since April, even if the third quarter has been more mixed than the second, and in other areas such as the property market which are seeing strong growth. It may be that this effect is negated by adverse news flow with respect to vaccine progress or further lockdowns, but in the absence of this we expect asset prices to be reasonably well underpinned by the support of central banks. There is also a broad consensus that government stimulus programmes should continue, even if there is disagreement on the exact details and form this should take in different countries.

Significant positive news in the development of one of the candidate vaccines, including a timetable for its rollout, would have a transformative effect on the market. Visibility on a return to normal for the travel and hospitality sectors is crucial; companies in those industries, which have suffered so much during 2020, may begin to find buyers at what are certainly depressed valuations. We are not sure that this will occur before the end of the year, but we want to be in a position to participate if this comes to pass. In the meantime, we expect markets to be somewhat volatile and have retained an elevated cash balance as a ballast in these uncertain times.

The US Presidential election in November is always a significant event with the potential to generate volatility. At present, polling indicates a lead for Joe Biden particularly amongst women but economic and campaign developments over the next few weeks could be crucial in what is sure to be a bitterly contested election. The news at the start of October that President Trump has contracted coronavirus adds a further twist. Were Biden to win, the most immediate effect may be a more cautious approach to 'unlocking' the economy if Covid-19 case numbers worsen. Beyond that, some healthcare reforms and an increase in the corporate tax rate are likely during the term, but it is hard to see his victory having a big impact on market sentiment in the short-term. However, a tight race with a contested outcome that drags through to January, possibly accompanied by civil unrest, may well sour sentiment significantly, and it would be unwise to rule out this possibility.

In the UK, the terms of the future relationship with the EU are still under negotiation ahead of the end of the transition period on 31st December, and this may weigh on UK assets including the currency – particularly if relations are less than cordial, as seemed to be the case in early September, or if no deal has been agreed by the time of an EU summit in mid-October. Given this risk, and the overall economic backdrop in the UK, we expect to keep exposure to UK equities quite light for the time being.