ROCQ CAPITAL

Fourth Quarter 2020

The coronavirus pandemic dominated once again in the fourth quarter as infection rates rose sharply in Europe and the United States, surpassing the highs previously seen in March. Further restrictions on movement were placed on citizens around the world to slow the rate of infection and to protect healthcare systems from being overwhelmed. Europe and the United Kingdom took action soonest and with far stronger measures than the United States, which will feed through into a delayed GDP impact in the US. Travel, hospitality, and service sectors continue to be hit far harder than manufacturing where the purchasing manager's indices (PMIs) suggest demand levels have been sustained.

Towards the end of November, the news from Pfizer, Moderna, and then Oxford/AstraZeneca that their newly developed vaccines had especially high efficacy rates boosted confidence that a return to something approaching normality is close. It will take months for large numbers of people to receive the vaccines and won't be a smooth path, but such news understandably boosted stock markets, and to such an extent that many equity indices hit new highs. As we noted in our Q3 Outlook, positive vaccine news did have a transformative effect on markets. The work from home darlings in the technology sector continue to perform well as many changes have now become permanent whilst the cyclical, value, and small cap segments of the market that had been punished by the impact from coronavirus were the leading beneficiaries of the vaccine news.

In the midst of the pandemic, the United States had one of the most controversial elections in recent times with incumbent President Trump refusing to concede defeat and filing lawsuits amid accusations of voter fraud that a variety of federal and state courts are yet to find merit in. Stock markets reacted positively to a Democrat victory with President-elect Biden certainly far less confrontational than President Trump. With Congress tilted towards the Democrats, there is a greater likelihood of tax and regulatory changes but these will almost certainly take a back seat as stimulus spending is likely to be of primary concern at the moment.

At year end, the United Kingdom finally completed its departure from the European Union, some four and a half years after voting to leave. From January 2021, free movement of the respective populations is gone and the UK is free to set trade policy as it wishes and negotiate deals with other countries. Whether or not the UK can negotiate free trade deals with countries such as Australia, New Zealand, and the United States, which the European Union does not have, remains to be seen. The Pound strengthened against the US Dollar in the final quarter, although given the much more muted move against the Euro, this appeared more a function of Dollar weakness than Sterling strength.

Emerging markets, and Asia in particular, were the primary equity market beneficiaries of a weaker US Dollar and hopes of a recovery in cyclical stocks, rallying almost 20% in the final quarter. Small caps were the only outperformers, with MSCI World Small Cap +23.6%. Europe was a relative underperformer although still recorded a double digit gain for the quarter. In the UK, the FTSE 250 (+19%) followed small caps globally and outperformed the large cap FTSE 100 (+11%).

Central bank policy continues to provide a support to government bonds and therefore fixed income in general, with the US Federal Reserve, Bank of England and European Central Bank all committing to further substantial asset purchases. Despite the economic outlook looking considerably rosier on news of the vaccine, government bond yields barely rose during the quarter as the buying from central banks kept a lid on any move upwards. The US 10yr rose from 0.68% to 0.91%, the UK equivalent fell from 0.23% to 0.20%, and the 10yr German Bund moved from -0.52% to -0.57%. With governments continuing to borrow heavily to fund coronavirus support programmes, and central banks continuing to run asset purchase programmes, rates and yields seem likely to remain low for some time yet.

Outlook

With interest rates in the major economies likely to remain at or near record lows for at least the medium term, combined with other forms of liquidity provision, we continue to see a generally positive outlook for risk assets in both equities and credit.

Speed of vaccine deployment will be critical in determining the path economies take in 2021. Timelines suggest that by the end of the first half of the year, those who want to have the vaccine will have been able to receive it, in major economies at least. This would provide a huge boost for hospitality and travel sectors if significant portions of the population can begin to move around during the summer and autumn at least. Pent up demand for holidays is substantial, particularly from countries who have suffered the most stringent lockdowns.

Within equity markets the question remains whether the recent outperformance of smaller companies and cyclical sectors is here to stay or whether this was merely a blip in the continued outperformance of large cap growth stocks. Reasonable cases can be made for both so the prudent investor will continue to hold exposure in the best companies within each style. The competitive advantage gained by some online companies during the 2020 lockdowns is unlikely to be reversed. Studies show that on average it takes just over two months to form a new habit so many of the changes are now well and truly engrained.

Fixed income markets remain tricky to navigate. Low or negative yields in major currencies make coupon clipping an unattractive strategy and the risk of a spike in yields if central banks reduce support or inflation picks up means investors need to be careful and seek out areas of fixed income markets than typically perform better in flat to rising interest rates. Floating rate notes and emerging market credit provide the opportunity to pick up yield when compared with high quality fixed rate bonds.

The UK remains significantly under-owned by international investors and with Brexit now resolved there are undoubtedly high quality companies listed in London that will attract attention from overseas investors who are less concerned about currency risk than they have been in recent years. We think this is a good opportunity to be invested in what is not an expensive market in advance of potentially significant inflows.

A weaker Dollar, driven by monetary and fiscal policy and central bank rates now in line with other major economies, should provide a tailwind for emerging markets, where we remain bullish. Particularly in Asia, these populations are significantly ahead of developed markets in continued digitalisation – again accelerated by coronavirus – and technology uptake. Many of the world's highest quality technology companies can be found in countries such as Taiwan and South Korea, as well as the obvious names from China. Elsewhere, growth rates will likely be significantly higher than developed markets with plenty of demand for goods and services, and countries such as Vietnam will benefit from companies moving "offshore" manufacturing away from China.