THE FRY GROUP
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Quarterly Investment Update

JANUARY 2021

Good news arrived

As we mentioned in our update last quarter, global markets were in a holding pattern. Much was expected from the US elections and also progress on the Covid vaccine front. It should be noted that the outcomes in almost all respects were favourable, leading to a general upsurge in positive sentiment in the market.

The biggest event was undoubtedly the US Presidential election, won by Joe Biden. In addition, the "Blue Wave" materialised as the Democratic Party tied for the Senate and won Congress, albeit with a slimmer margin than before. A tied Senate leaves Biden theoretically in control of both houses, as the Vice President has a veto in the event of a tied Senate vote.

Markets have taken the view that for the first part of the new Administration's term there will be appreciable and ongoing efforts to keep up the stimulus that has been pumped into the US economy, to stave off the negative impact of the pandemic.

The news of vaccines becoming available, and their subsequent roll-out, was a further boost to market sentiment. The general direction of economic data releases had been positive before the news of ambitious roll-out programmes in several countries. This came in time to counter-act the potential damage that could have been caused by the news of new strains of Covid and their rapid spread.

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Market Focus

Global fixed income

Government bond markets seem to be trapped in something of a conundrum. While the release of fresh funds into the economy provides a much-needed boost and has raised inflation expectations, this has been tempered by actual inflation and the knowledge that the Fed is keen to keep the yield curve flat through its purchase program. For the first time since the modern advent of quantitative easing in 2008, governments are stepping up in a significant way by adding outright deficit spending to the policy mix. Before, it was left to the central banks to lead the way with their balance sheet expansion. The hope is that the extra impetus from the fiscal side will bring the growth and inflation trajectory that has been lacking to date.

The fate of emerging market bonds is often intertwined with movements in the US Dollar. In an environment where the overall market sentiment is one of optimism and favourable to risk assets, the Dollar has been under some pressure, and emerging bonds have found some favour. When measured by their yield gap to US bonds, EM debt had recovered quite well by the end of the year after suffering along with the rest of the universe of risky assets in Q1 and Q2.

The same general idea holds for other credit markets: the stable platform provided by good news flow and policy support in Q4 allowed the market to keep its recovery on track. There were very few scares in the credit space, and default rates are certainly very well-behaved considering how damaged some parts of the economy still are.

US

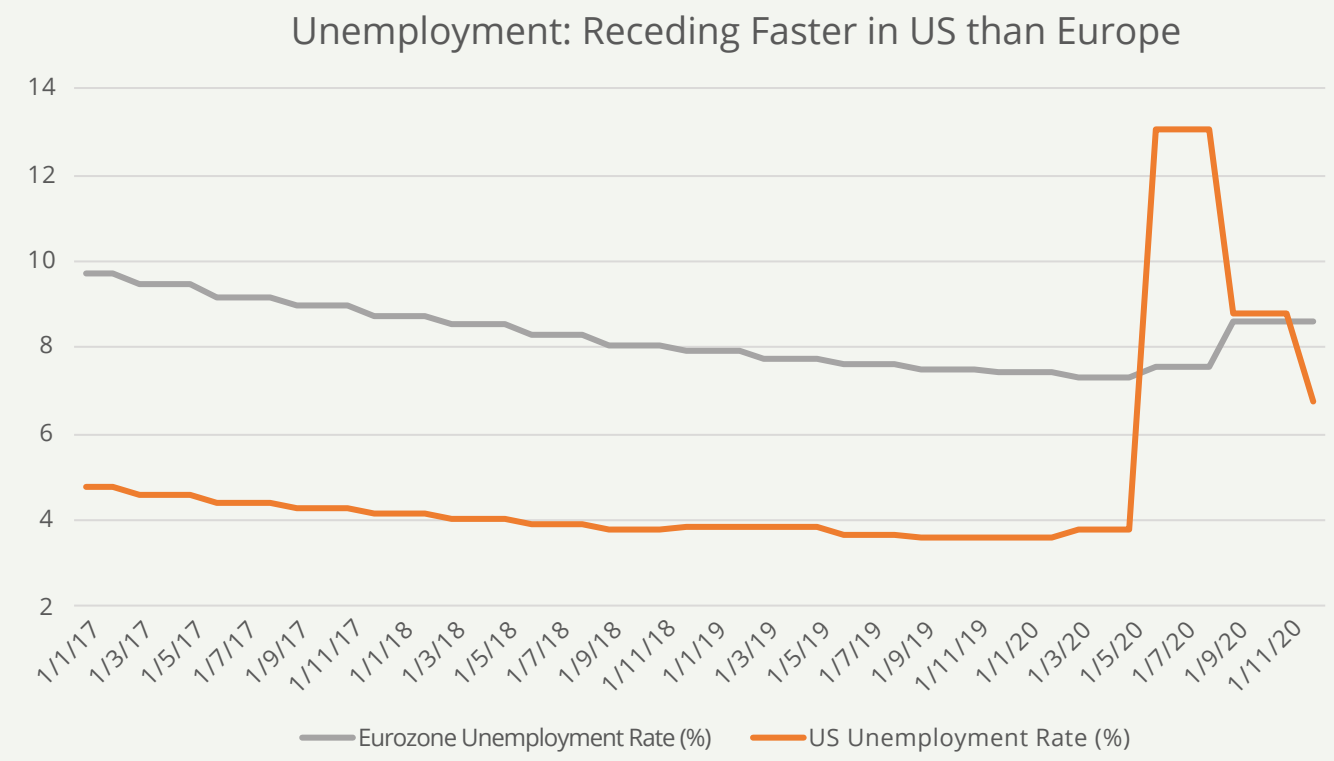
The US economy has shown a reasonable degree of resilience in response to heavy government spending. Nonetheless, some areas, including the total level of employment, are still languishing behind the levels seen just before the Covid outbreak hit. That said, the performance of the stock market, previously led by the tech sector, has broadened out in Q4 and saw the return to partial favour of other sectors that have lagged thus far, including energy and financials.

It is fairly clear that much of the gains in the equity market have been driven by liquidity and momentum as opposed to an expected rebound in corporate earnings. With the Fed entirely committed to a regime of low interest rates, the environment has been created for a rotation into equity that could sustain for as long as there is belief in a sustainable economic recovery, coupled with a mild uptick in inflation.

UK

In Q4 the UK equity market finally started showing signs of catching up with the global market recovery, having languished behind for the best part of the year. As the uncertainty around a hard Brexit was taken away, and global investors started to hunt for cheaper opportunities in markets that had lagged, UK equities benefited.

A further boon to risk sentiment has been the roll-out of vaccines that offer the hope of a more sustainable recovery into the second half of 2021 as the necessity of more damaging lockdowns ease and the economy has a chance to regain its footing. As is the case in the USA, the monetary policy environment is going to be benign for a foreseeable period. The Bank of England has signalled its intent to maintain a very accommodative stance.



Source: Bloomberg

Europe (excluding UK)

As was expected, the data reflecting the European recovery showed that it is not quite on par with the US, however things may have been worse. A contraction was widely expected, but the actual outcome of a 7% drop in GDP was in fact somewhat better than initial forecasts had been and running into Q1 of 2021 a further contraction is still very much on the cards, albeit of nowhere near the same magnitude as Q4. In some countries, such as France and Spain, industrial production numbers for November showed that the impact of the second lockdowns was less severe than initially feared. This may be because firms were better prepared this time around with more mitigation strategies in place compared to the first round.

It is still too early to make similar statements about the services sector, as more data would be required. Initial estimates point to a similar scenario as physical output: a very clear negative impact on the recovery, but less than feared given the experience of the first round. Looking forward to the start of 2021, Europe's recovery still has a sense of uncertainty about it.

Driving the uncertainty is of course how countries respond to the continued spread of the virus, coupled with the speed and efficiency of the roll-out programs in the various countries. With a change in risk sentiment noticeable globally, Europe continues to lag as the policy responses that have been effective elsewhere are not being implemented in Europe with the same vigour. In fairness to the ECB, interest rates had been low for some time before the pandemic struck and thus leaves it with less room for manoeuvre compared to other central banks.

Japan

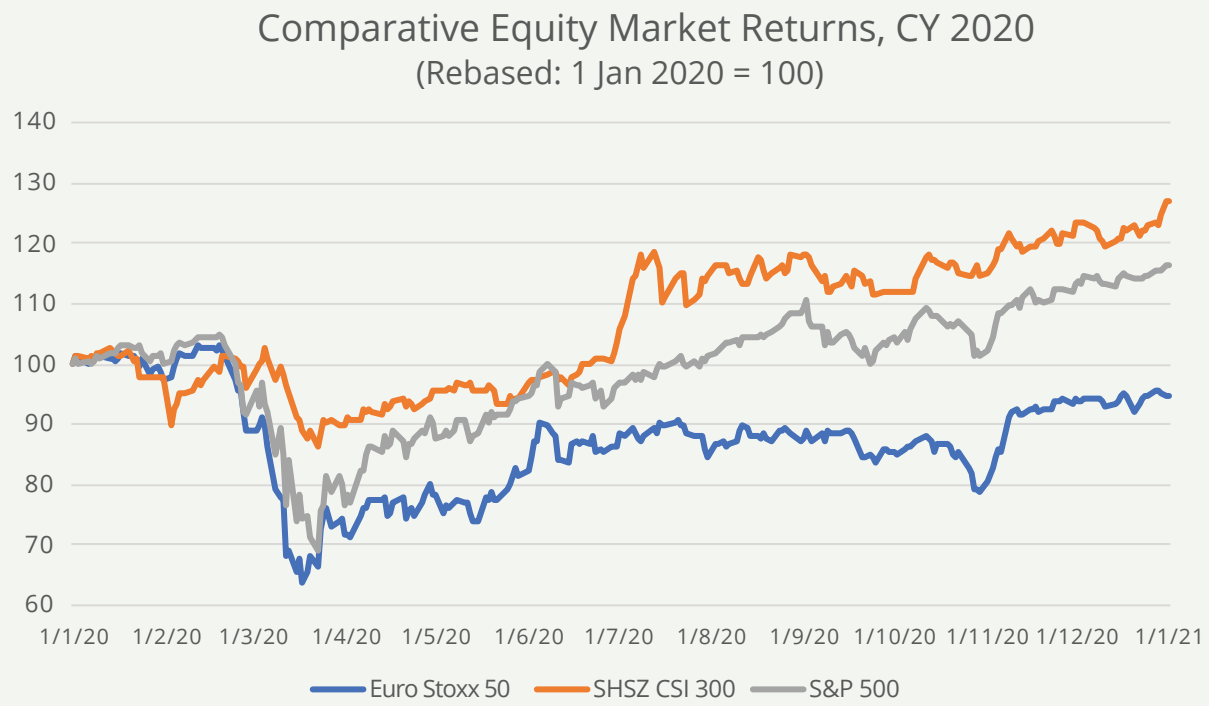
After a comparatively docile run in Q3, Japanese equity had a very strong final quarter, driven by a strong run specifically in November. At the time, the Japanese handling of the virus was viewed as a positive, as was the fact that Japanese equities had - like the UK - lagged the global market.

Subsequently it has transpired that the virus had other ideas, and renewed curbs had to be imposed. In a pattern that has repeated in other parts of the world, production levels are likely to remain reasonably firm, with services and consumer-oriented areas more likely to be impacted. Despite these developments prompting the Bank of Japan to lower its inflation forecast, further policy action is unlikely to be forthcoming.

Emerging Markets

The standout performer in the Emerging Market bracket remains China. In the last quarter the equity market powered ahead by 13.6% (Shenzen 300 Index). In stark contrast to other regions, especially Europe, estimates for Chinese GDP are running close to 6% for the final quarter of 2020. The major contributors to growth were broad-based, with exports ahead of expectations, driven by a burgeoning trade surplus. Inflation also surprised to the upside by the end of the year.

One potential dark cloud on the horizon, credit defaults, looks to have abated for the immediate future. For the first time, the Chinese government has begun to allow larger number of corporate and state-owned entities to fail. This is to be taken as a sign that authorities are keen to foster a climate of accurate credit pricing, as opposed to keeping failed entities afloat, distorting the cost of capital.



Source: Bloomberg

Conclusion

In Q4 the worst of the ravages of the virus was counteracted by strong policy in some countries, when the risk was that there would be a failure through neglect or gridlock. Looking ahead, the renewed vigour of outbreaks has introduced the same risk again. In the US, the new Administration has already signalled its willingness to spend aggressively to ensure no further relapse into a deep recession. Other countries have not yet signalled the same intent, or might find themselves more constrained by the reality of stretched policy. The presence of a series of seemingly effective vaccines also changes the landscape compared to just a few months ago.

The divergent paths of policy responses make it quite possible that asset markets will also diverge along regional lines, with the growth winners the clear ones to be backed, leaving the laggards to be invested in at a later stage.

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