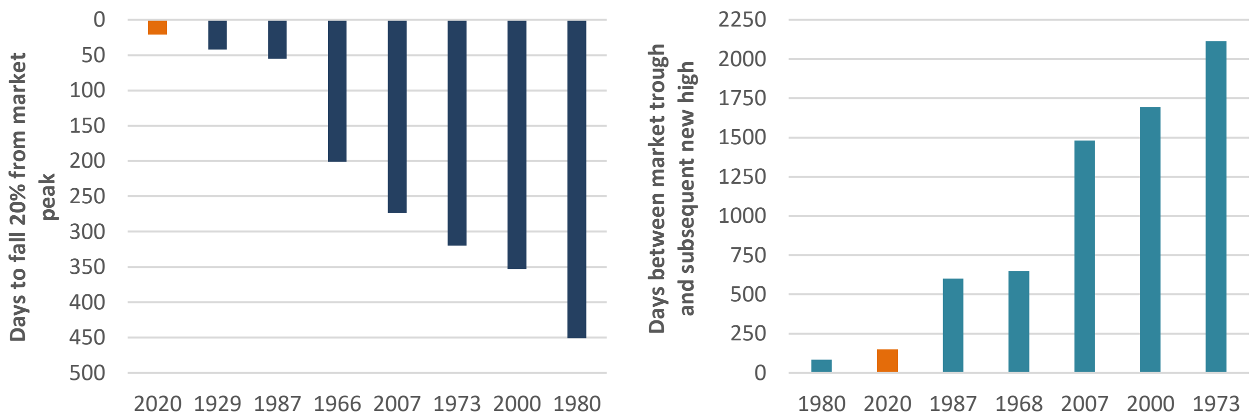
INVESTMENT UPDATE: AN EXTRAORDINARY YEAR

4th September 2020

By any standards, 2020 has been an extraordinary year. Economic and social activity has been restricted to a previously unthinkable extent all across the globe as policymakers have struggled to limit the threat of the Covid-19 virus. In just a few short months, lives have been sadly lost and many more have been altered beyond recognition. Meanwhile, central banks and governments have unleashed experimental policies on an unprecedented scale to try to limit the economic fall-out of the pandemic. Against this backdrop, it is perhaps no surprise that developments in financial markets have also been extraordinary.

Equity investors often define a “bear market” as a fall of 20% or more from the peak. By this measure, the descent into bear market territory in February and March was among the fastest on record. US stockmarket indices took just 21 days to fall 20% from their mid-February peaks – only the stock market collapse at the start of the Great Depression in 1929 comes close, but even that took 42 days. By way of contrast, it took US stocks 274 days to fall 20% in the Financial Crisis of 2007-2008. However, the recovery since has been almost as remarkable. Staying in the US, equity indices reached new highs just 148 days after their late March lows. This recovery has been ten times faster than the recovery from the Financial Crisis. Placed in this historical context, it becomes clear quite how extraordinary 2020 has been (see Figure 1).

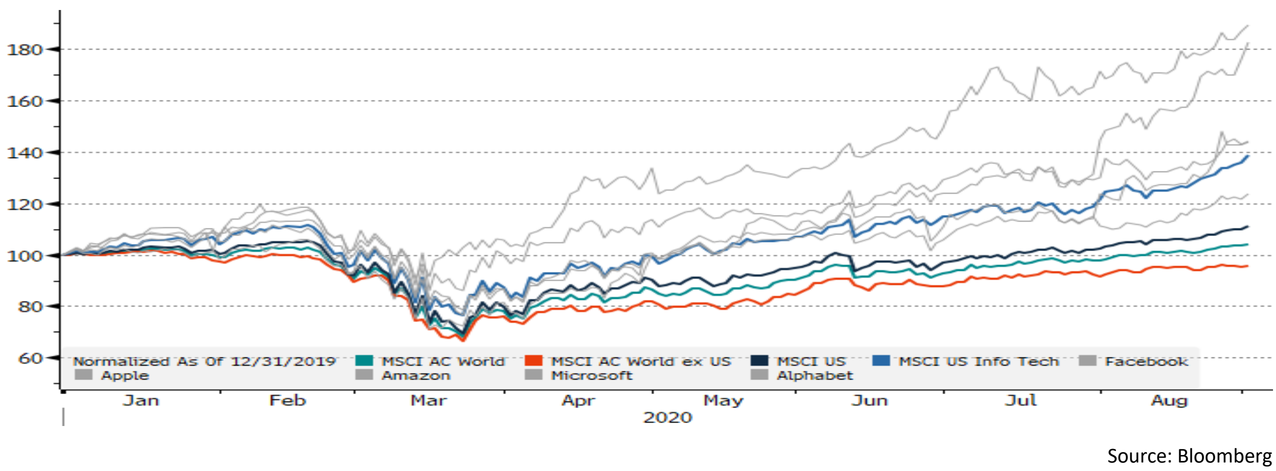
Figure 1: The speed of both the stockmarket decline and the subsequent rebound in 2020 have been extraordinary



Sources: Standard & Poors, JPMorgan Asset Management, BoA Research Investment Committee, Bloomberg

The recovery, however, has been far from equal. US technology stocks – most notably the “FAAMG” grouping of Facebook, Apple, Amazon, Microsoft and Google’s parent company Alphabet – have risen sharply. These five companies between them are accountable for nearly 85% of the gains made by the US stock market as a whole. Once Tesla and Nvidia are added in, we calculate that 98% of the US stockmarket’s 12% year-to-date gain is due to the share price performance of just seven companies.

Figure 2: US stocks – and US technology stocks in particular – have led the way so far in 2020



Source: Bloomberg

These seven companies have had an extraordinary impact not only on US stockmarket returns, but even on the performance of global stockmarket indices. The MSCI All Countries World Index is now in positive territory for the year to date, up 4% having fully recovered from March's bear market. However, if we exclude US stocks – the performance of which is, as we have seen, explained by just those seven stocks – the index is 4% down, still to recover its pre-crisis peak (see Figure 2). In other words, just seven companies have made the difference between gains and losses for the global stock market as a whole.

While we must of course remain cognisant of a raft of issues and developments – not the least of which include the risk of a second wave of infections, the extent of ongoing monetary and fiscal policy support, the reslience of the nascent economic recovery, the upcoming US presidential elections and the apparently stalling Brexit negotiations – this phenomenon presents a challenge as we seek to develop a meaningful market outlook. To some extent, even when investing through highly diversified portfolios, our outlook for global stock markets should arguably be impacted by our view of just a handful of companies.

How then should investors deal with this extraordinary predicament? As ever, we would counsel investors to focus on valuations.

The extent to which US technology stocks have risen so far this year has left them looking extremely expensive by any number of measures. While we have some sympathy with the view that many of these companies are global market leaders that are benefiting from structural social and economic change, we think even the best companies can be poor investments if the price is too high. Though we appear to be in the minority, we believe stock prices in the US technology sector are now too high.

However, outside the narrow band of heralded market leaders, we believe equity valuations are, for the most part, reasonable. Economic activity is picking up as measures to contain the pandemic are slowly relaxed, yet there remains plenty of scope for monetary and fiscal policy to remain exceptionally supportive for some time still to come. This combination of reasonable valuations and an improving economic backdrop augers well for long-term investors in equities.

We recognise the importance that a small number of names have had to the extraordinary stockmarket story that has unfolded so far in 2020. We further recognise that, should others come to share our scepticism over the valuations at which these stocks are now trading, global equity markets could face a meaningful headwind if recent gains for these stocks are rescinded. We are therefore underweight equities across the OMPS portfolios. However, we believe that valuation is the key to successful investment and that, by ensuring portfolios contain exposure to other, more reasonably valued parts of the global equity market, investors will be well-placed to benefit from the global economy's ongoing recuperation from a truly extraordinary year. For this reason, our equity underweight is concentrated in the US. We remain overweight UK and emerging market equities – two markets where we believe valuations are most attractive, and where consequently we believe the prospects for longer-term investors are strongest.

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