Lincoln Private Investment Office

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Investment Letter – Q3 2020

"The leader of the market today may not necessarily be the leader tomorrow." Ma Huateng, CEO of Tencent

The quarter closed with a pugnacious US presidential debate, cementing investor focus on the much-anticipated US election. Having commented in our last letter on the implications of the result on November 3rd, we are instead going to look at opportunities away from the US, where we see structural factors that may prove more influential on long-term investment returns. Before that, we touch on two of the quarter's more noteworthy events.

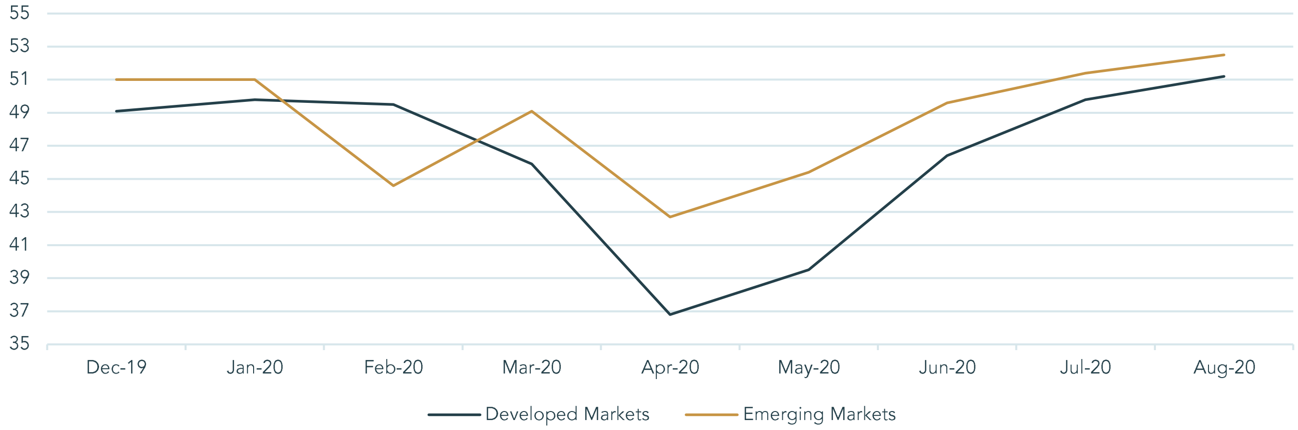
In September, Japan underwent a leadership change, as Shinzo Abe announced his resignation following a deterioration in his health condition. Whilst Abe's health troubles have been public knowledge for some time, the timing and speed of the announcement came somewhat as a surprise. His former chief cabinet secretary, Yoshihide Suga, was swiftly elected by the ruling Liberal Democratic party as his replacement. As the continuity candidate, Suga is likely to pursue similar economic policies to his predecessor, particularly in relation to corporate governance reforms in listed Japanese companies, which are a key attraction for foreign investors. The real test will come over the next few months, as Suga looks to maintain the political momentum that Abe built over his 8 years in power. Seemingly unphased by the news, Japanese equities recorded strong gains of over 4% for the quarter.

The overhaul of the US Federal Reserve's inflation target was another material event; a result of the Fed's review of its monetary policy framework that has been ongoing since 2019. The Fed Chair, Jerome Powell, announced that the world's most influential central bank will move away from a fixed 2% annual inflation goal to a flexible 2% average target over a multi-year period. In so doing, the Fed abandoned its previous strategy of pre-emptive interest rate hikes to prevent a spike in inflation, allowing instead for temporary fluctuations in inflation above or below the 2% mark. This change, along with the Fed's explicit commitment to unemployment targets, paves the way for a sustained period of ultra-low interest rates and provides support to a fragile US economy.

Equity and bond markets were quite muted in their response to this policy change. US government bonds saw a small rise in yields on the day, certainly small in comparison to the wild moves we saw earlier this year. In equity markets, the anchoring of low interest rates helped to drive an outperformance by cyclical equities, such as industrials, as markets perceived more support for the real economy in early September. This relative performance gap was closed by the end of the month, as fears of the pandemic's second wave weighed on cyclical sectors. The true effect of the Fed's policy change will play out over a much longer timeframe. If the Fed is successful in generating economic growth and inflation, asset-backed 'value' equities should outperform more expensive 'growth' peers, whilst real assets such as property and gold should also fare well. Given the inflation risks mentioned above, we maintain our view that conventional government debt is not an attractive asset class, as inflation will erode the real value of these bonds, which currently only offer modest yields.

Whilst US and European institutions stimulate and spend to re-start economic activity, the outlook in emerging markets appears to be more positive. The pandemic's impact on economic growth has been generally less extreme in the emerging world, with these countries forecast to see GDP declines of less than 2% in 2020, compared with 6% declines in developed economies. Indeed, China, Indonesia and Vietnam are among the economies expected to deliver positive GDP growth this year. Emerging economies have benefitted from a range of factors, including earlier lockdowns, lower infection rates, strong pre-Covid momentum and a lack of infrastructure to support extended lockdowns. Purchasing Manager Indices (monthly surveys of economic activity) confirm the superior economic health of emerging markets, as depicted in the chart below. In fact, countries such as South Africa and Brazil have posted higher index readings than at the start of the year.

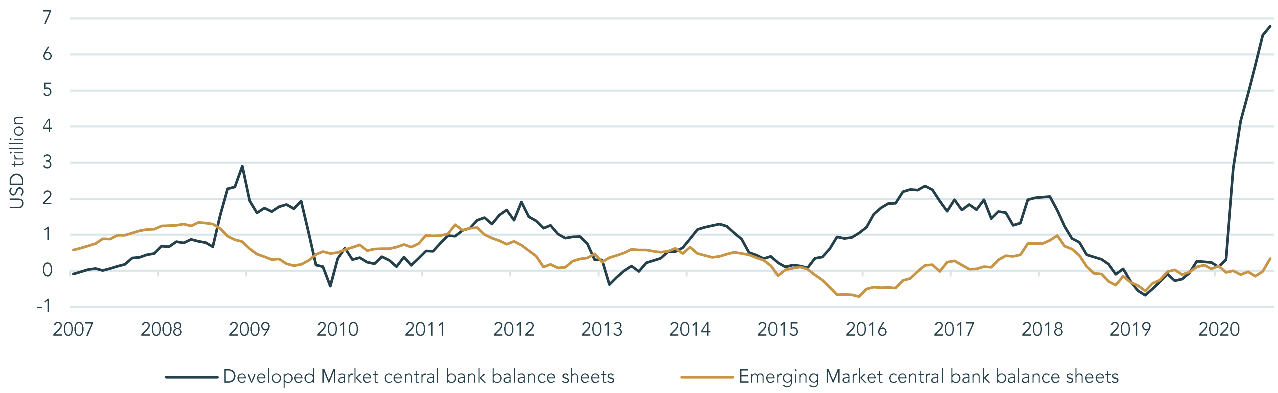
Aggregate PMI Readings Year-to-Date



Source: Bloomberg LLP, 2020

This economic divergence is creating investment opportunities. Whilst many central banks devise innovative, expansionary measures to support their economies, there are significant regions of the emerging world where monetary policy continues to be conventional in nature. Underlining this point, Chairman Guo Shuqing of the China Banking and Insurance Regulatory Commission said in June that China "values very much the normal monetary and fiscal policies we are practising now. We will not flood the economy with liquidity, still less employ deficit monetisation or negative interest rates." Expectations of normal economic growth and orthodox monetary policy seem very attractive given the economic backdrop elsewhere. The meaningful contrast between expansive monetary policies in the developed world and emerging markets is shown below, with developed markets undertaking huge balance sheet expansion through measures including bond buying programmes. Going forward, central banks in emerging economies will have more firepower to support their economies, if required.

Net Change in Central Bank Balance Sheets



Source: BlueBay Asset Management, 2020

We believe this money printing in the developed world will lead to an oversupply of developed market currencies. The US Dollar Index, a measure of the purchasing power of the US dollar against a basket of other global currencies, fell 3.6% in the last three months, its worst quarter in three years. Whilst this is a supportive first move for emerging economies, we expect further dollar weakness in the coming years as the dollar retreats from years of structural overvaluation.

Whilst the dollar weakened in Q3, the US equity market posted a very strong quarterly return of 8%. This performance was driven by a handful of large technology equities with attractive growth rates, in some cases enhanced by the pandemic. Amazon, for instance, finished September with share price gains of 70% for the year to date. Whilst undoubtedly a beneficiary of the lockdowns imposed across the world, Amazon now accounts for 5% of the S&P 500 Index after its impressive recent run. This concentrated performance has helped push the S&P 500 to a much more expensive valuation than other equity markets.

High growth companies that trade at more reasonable valuation levels can be found in emerging and Asian equity markets, with obvious examples being Tencent and Alibaba. These companies can scarcely be avoided in day-to-day life in Asia. Both businesses have produced resilient growth through the pandemic, with Tencent delivering 27% revenue growth year-on-year in Q2 2020 and Alibaba delivering 33% growth in the same period. Whilst these growth rates are reflected by the premium valuations of both companies, their shares are more attractive when placed alongside US peers. Alibaba is valued at half the forward earnings multiple of Amazon, for instance. At a higher level, we note that Asian economies, excluding Japan, make up 29% of global GDP and 21% of the world's exports, yet their equities account for 7% of the global equity market. We see scope for broad-based strong performance from Asian equities in the years to come, as financial markets catch up with economic reality.

As we move into the final quarter of the year, there are three distinct events that the market remains very focused on: a potential vaccine for COVID-19, the outcome of the US election and Brexit negotiations. It is quite conceivable that there will be a resolution to one or more of these in the coming months, which will provide markets with some much-needed certainty. We are mindful of the possibility, however, that none of them will be settled by year end, causing further volatility. We are therefore positioning portfolios to reflect this balance, whilst noting the strengthening of some equity market themes that give us increasing cause for optimism.

Fred Hervey

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