Investment Office Third Quarter Update 2020

Welcome to our report on the third quarter of 2020 and our outlook for investment markets.

The mainstay of portfolios, global equities and bonds, continued their liquidity-driven recovery into the third quarter, as on-going fiscal and monetary support to alleviate the economic pain of the virus related lockdowns, buoyed risk assets through July and August. September, however, became the month the West realised it needed to evolve to live with the virus longer term and that the initial emergency measures could not and should not be repeated. Instead, more measured approaches are being adopted to increase economic activity and reduce support whilst keeping a lid on the rising caseloads of the second wave.

The total number of daily new cases reached new highs with Europe, in particular, trending upwards, as Spain and France were especially hard hit. Better testing and tracing capacity has allowed European policymakers to tackle this wave with targeted measures so far, including travel restrictions or the requirement to wear a facemask in public, instead of the more economically damaging blunt instrument of broad national lockdowns. Experiences have differed from country to country. While London's tube use remained over 60% below pre-COVID levels, China's incredible success in containing the virus has allowed subway use in its major cities to recover to just 10% below levels seen last year. This, alongside US dollar weakness, has driven Asia's strong relative performance over the quarter, making it the joint best-performing equity region year to date, up over 5% (in sterling terms).

Markets in July were mixed, as regions reacted to data releases confirming the severity of the downturn in the second quarter. US equities shrugged off the bad news and led the gains throughout July, supported by robust quarterly earnings from the biggest technology, media and online distribution companies. This was at odds with the situation in Europe, with Eurozone equities down over the month. Government bond yields also fell on this disappointing economic data.

A more positive story emerged throughout August as major data releases pointed to continued economic recovery. Consequently, shares were broadly higher all round in August, with US equities reaching all-time highs. Indications that the worst of the economic dip was over usurped escalating tensions with China, with Washington clamping down on Chinese chipmakers and the World Trade Organisation ruling that tariffs imposed on Chinese goods in 2018 were "inconsistent" with international trade rules.

In a significant shift in monetary policy, the Federal Reserve announced a move towards average inflation targeting, allowing inflation to run above the 2% target to compensate for periods of below-target inflation. Rates are therefore likely to remain lower for even longer, providing lenders with ongoing easy conditions for an extended period and greater clarity in their business planning. Emerging market equities were pushed further upwards on the back of this news. Aside from this adjustment, major central banks took a back seat throughout August, having already brought rates close to their lows and flooded the market with liquidity. Governments, however, have faced further pressure to provide additional fiscal support. Congress debated the extension of unemployment benefits and provision of stimulus cheques, with congressional disputes delaying the approval of a new package.

Sandaire
105 Wigmore Street London W1U 1QY
Telephone +44(0)20 7290 5200 Fax +44(0)20 7495 0240
info@sandaire.com www.sandaire.com

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Towards the end of August, Shinzo Abe, Japan's longest-serving Prime Minister stepped down on health grounds. The Liberal Democratic Party elected Yoshihide Suga to stand in for the remainder of Abe's elected tenure, which was due to end next September. Suga, the son of a strawberry farmer, had been a long-standing supporter of Abenomics, and thus his appointment was a vote for continuity in a time of uncertainty.

For much of the year, the gap between winners and losers had never been starker, with e-commerce and 'new economy' stocks performing strongly, while those from 'value' parts of the market, such as airlines, banks, and commodity producers, suffered severe share price declines. In this environment, the tech-heavy US equities led returns while value-tilted UK equities suffered. September, however, saw a tentative correction in these US growth stocks, which came under some selling pressure, having benefited so far this year from the pandemic-induced shift to online services. The slight outperformance of value may indicate a reversion of the growth/value trade, as sales at physical stores begin to rebound, while online sales are declining from stretched levels.

September also saw a meaningful move lower in sterling, likely due to the lack of progress in the Brexit negotiations. Brexit discussions were further complicated by the placing of the Internal Market Bill before parliament, in an attempt to override terms of the EU withdrawal agreement regarding trade between the UK and Northern Ireland.

Outlook

The immediate outlook for markets is uncertain. On the one hand, equity valuations look stretched relative to recent history, but on the other, a sharp fall in earnings for 'old economy' businesses means that if economic conditions do normalise, we can expect to see earnings recover and valuations look more attractive. Key to this will be how events unfold over the next few months. Of greatest importance is the future role of the virus. Recent climbs in daily case numbers are at odds with the death rate figures, which have fallen considerably over the past few months. Better medical treatments, increased use of facemasks and a shift in the incidence of cases towards younger people perhaps may explain this. However, hospitalisations have recently started to creep up after remaining at depressed levels throughout the summer, prompting concerns that deaths could start to rise more meaningfully as temperatures drop heading into winter.

Although lockdowns of the scale we saw in the spring are unlikely, further waves will provide ongoing repeated set-backs for economic activity as re-openings are delayed, jobs are lost and renewed social distancing measures impact consumer motivation, confidence and thus consumption. Recent consumer spending data across the Atlantic and in Europe gives cause for optimism, and the prospect for a vaccine (several firms are in stage 3 testing) may entirely nullify its threat.

Most major economies announced unprecedented fiscal support within weeks of the onset of the pandemic. In the US, real personal income growth remarkably accelerated in the second quarter as transfers from the government far outweighed the declines in wages. However, fiscal policy has begun to turn less accommodative more recently, with the rolling off of government support schemes, which, until now, have kept average wages buoyed considerably and staved off a reduction in consumption that could have arisen on the back of job security concerns. As

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an example, although an improvement from the 30% peak, around 10% of UK jobs remained on furlough at the start of September; so with the termination of the scheme at the end of October, a rise in unemployment will ensue and potentially damage confidence. In contrast, support measures for workers affected by Covid-19 have been extended in Europe, whilst in the US, funds in the Paycheck Protection Program to provide loans for small businesses have been used up. Weekly unemployment payments in the US have fallen from around $25 billion to $8 billion from the end of July, and although Trump recently redirected money allocated for the Federal Emergency Management Agency to unemployed workers, the funds will shortly be depleted.

The inability of the Republican Senate and Democrat-controlled House to agree on further fiscal stimulus to support those out of work has given even more importance to the race for the White House. Whilst Biden, the Democratic Party nominee, currently has a modest lead, he has been losing ground in recent weeks. Polls now indicate that Trump has gained ground in some key swing states, but has to make gains in at least two further key swing states if he is to retain the presidency. Political risk is therefore likely to increase in the fourth quarter, with a particular focus on whether the US passes further fiscal stimulus.

From a monetary and fiscal stance, the lack of negative consequences of the increase in the money supply, yet benefits in terms of maintaining the standard of living of the populous, means we can expect policy to remain extremely accommodative, with governments very unlikely to attempt the balanced budgets we saw in 2010 after the global financial crisis. Although the virus has had a disinflationary impact so far, US and UK consumer spending have reached new highs. The ECB and Federal Reserve are both keen to moderate currency appreciation, with the US having, so far, provided more stimulus to markets. With bank balance sheets in reasonably good health, and consumers for the first time having more money in a recession than they did before, we can expect to see a pick-up in money velocity, which would usually lead to inflation eventually, perhaps in 12-months or so. In this outcome, we might expect to see 'value' stocks recover, and fixed income (bonds, both sovereign and corporate) would come under pressure and values fall.

Volatility will likely remain a feature of markets in a likely eventful next three months. By the turn of the year, the outcome of the US election, the UK's post-Brexit trade position, and Congress' stance on further fiscal stimulus should all be decided. We are also cognisant that the development of a successful vaccine or further waves of infections could send markets in very different directions. In such uncertainty, we reiterate our previous statements that diversification, both at the top asset class level and regionally, is key. Diversifying strategies will therefore play an increasingly important role in portfolio composition going forwards.
We recently decided to maintain our top-level tactical asset allocation stance of being neutrally weighted to global equities, underweight fixed income and a compensatory overweight in diversifying assets such as gold and hedge funds. Despite more elevated market levels, there remain good active opportunities within equities for our underlying managers to achieve good relative returns regardless of the direction of the broader indices. We have been reducing exposure to growth equities in favour of value stocks, having seen the extremes in relative valuation between growth and value reach new levels. Although further waves of the virus could further boost growth stocks, the availability of a vaccine would likely be a game-changer for markets, with investors shifting from the "pandemic trade" to the "reopening trade". Such an environment will support cyclical stocks, such as hotels and transport that were brought to a standstill by lockdown measures.

Regionally, we are continuing to run a modest US overweight (relative to our long term forward looking allocation) given the quality of technology-focused stocks listed there which have been able to continue to grow revenues despite the challenges in the economy. A weaker US dollar and the remarkable recovery of China and the other Asian countries first hit by the virus could help propel international stocks higher over the next 12 months. Our Emerging Markets / Asia underweight is relative to our forward-looking allocation, and does not reflect any concern with this region. Both the US and Emerging Markets positioning actually brings our allocation closer to the current capital weighted global norm.

With bonds now valued at all-time highs and yields at all-time lows, fixed income investments look very challenged, unless central banks move further into negative rates, or engage in more rounds of quantitative easing and bond buying. Accordingly, we plan to further underweight the asset class in time, seeing the fixed income portion of portfolios, not as a centre of future returns, but playing a role simply as a portfolio risk diversifier. Accordingly, as we begin to further reduce the allocation to fixed income, we will likely increase the duration of the assets to maintain similar risk characteristics with the reduced capital. Capital may be reassigned to other diversifying assets where a regular and above inflation return is more likely, such as government backed infrastructure, music and media rights, and selected property opportunities.

Summary

Concern is often voiced about stock market index levels, perceiving them to be high in the face of 'virus subdued' global economic activity. While US markets may have hit new highs in July, the 'premium' received for taking on global equity risk is still handsomely 5.5% above the 'risk-free' rate due to the US 10 year treasury yield and other western sovereign debt paying so little by way of return. So, in relative terms, the equity market is well supported by capital seeking some semblance of an above inflation return. Looked at another way, the cyclically adjusted average price to earnings ratio for global stocks is now 25 times, a figure much lower than during the period 1988 to 2008 and not excessively high compared to recent years. For those concerned that the debasement of currency via the printing presses will ultimately lead to inflation, then equities and tangible assets such as gold and property have traditionally fared well in such an environment.

It is also worth pointing out that market indices represent the average of 'today's' companies with a bias towards the larger well-established firms. However, today's winners can be tomorrow's losers, and quickly so in an environment such as this where former business models are being challenged and new ones adopted.

Accordingly, we feel the current environment provides us and our active managers with an excellent opportunity to gain from the turmoil.

Written by StJohn Gardner
Sandaire Chief Investment Officer
1st October 2020

Sandaire
105 Wigmore Street London W1U 1QY
Telephone +44(0)20 7290 5200 Fax +44(0)20 7495 0240
info@sandaire.com www.sandaire.com

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Asset Returns: Total Return in GBP

Asset Class	Index Tracking ETF Name	3 Months 30/06/20 - 30/09/20	1 Year 30/09/19 - 30/09/20	2 Years ago 30/09/18 - 30/09/19	3 Years ago 30/09/17 - 30/09/18	4 Years ago 30/09/16 - 30/09/17	5 Years ago 30/09/15 - 30/09/16
Global Equity	SPDR® MSCI All Companies World Index ETF	3.5%	4.9%	7.2%	12.8%	14.9%	34.6%
Global Fixed Income	SPDR® Bloomberg Barclays Global Aggregate Bond ETF GBP Hedged	0.5%	2.9%	6.5%	-1.6%	-1.2%	6.53%
Diversifiers (Hedge funds)	UBS ETF HFRX Global Hedge Fund GBP A Acc	1.4%	-1.5%	-4.4%	-3.0%	3.0%	-0.8%
Gold	iShares Physical Gold ETF	1.0%	20.4%	32.1%	-5.0%	-6.1%	35.8%
UK Commercial Property	iShares MSCI Target UK Real Estate ETF GBP Dist	-0.4%	-9.4%	7.4%	2.4%	2.7%	-4.5%
Private Equity	iShares Listed Private Equity ETF USD Dist	-1.5%	-11.3%	15.5%	9.1%	23.2%	34.5%

Source: MorningStar

Where the exchange traded funds (ETFs) representing the performance of each asset class do not have a pricing history covering the full 5 years, a comparable alternative fund or ETF has been used. If you require a current portfolio valuation or wish to discuss your portfolio, please do not hesitate to contact your usual Sandaire contact.

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Currencies

Currency Pair	Spot Price at 30.09.2020	3 month change to 30.09.2020	12 month change to 30.09.2020
GBP/USD	1.2911	4.30%	5.05%
GBP/EUR	1.1014	0.04%	-2.29%
EUR/USD	1.1722	4.26%	7.51%

Source: Bloomberg

Past performance is not a guide to future performance. The value of investments and the income from them may fall as well as rise and is not guaranteed. Consequently an investor may not receive back the amount originally invested. If performance is denominated in a currency other than that of the country in which you are resident, the return may increase or decrease as a result of the currency fluctuations.

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