TPO Investment Market Update

2021 to be the year of COVID-19 vs the Vaccine.

15th January 2021

The economic disruption of last year looks set to continue into 2021 as the world struggles to contain the spread of the virus, even as vaccination programmes start to be rolled out. Much depends on Government and central bank support which is likely to last longer than the disruption caused by the virus. It will therefore act as a slingshot to recovery when that comes. In this update we take a look at some key themes for the coming year.

2020 in the mildest of terms was eventful. The pandemic brought a global economic shutdown, the subsequent lockdown measures brought forward a new digital world and central bank intervention continues to challenge the tenets of traditional financial theory.

Looking forward we have identified five key themes which we think will shape financial markets in 2021:

1. ECONOMIC ACTIVITY

2021 will probably be determined by the progression of the vaccine rollout and the duration of lockdowns.

World GDP is expected to increase 5.4% in 2021 vs the 4.1% contraction we saw in 2020. This does, however, mask that certain countries will vary with China recording an 8% increase in GDP whereas the UK is expected to have the largest (absolute) increase with GDP increasing 6.4% from the 10.7% contraction recorded in 2020 (Figure 1a).

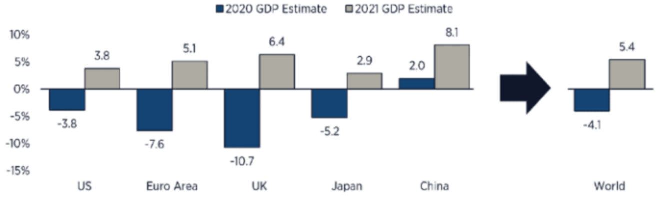

Figure 1a: GDP forecast of major economies in 2021 (Source: JP Morgan)

Uncertainty presents challenges to forecasting; under a 'worst case' scenario we may see output in the UK fall until 2021 Q2 (Figure 1b), but that would be lower (in absolute terms) than the fall seen at the beginning of the pandemic.

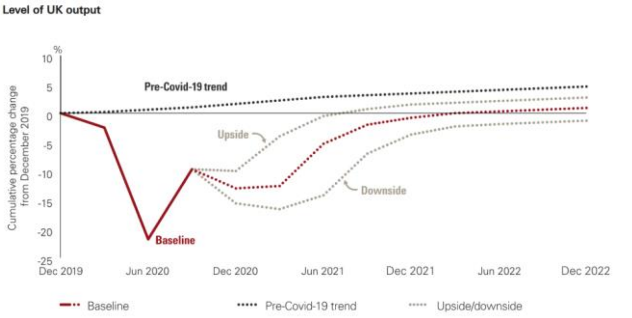

Figure 1b. Forecasted level of UK output (Source: Vanguard)

2. FISCAL AND MONETARY POLICY

As with the Global Financial Crisis of 2008, central banks and governments have intervened with aggressive expansionary policy decisions which have underwritten the global economy.

Conventional monetary policy has become exhausted with policy rates falling across the world excluding Asia with the expectation that rates will remain at historic lows for longer (Figure 2).

We urge you to stay safe and remember that your TPO advisers are here to guide you through this storm. If you have any questions or concerns, please do get in touch.

The value of investments can fall as well as rise. You may not get back what you invest.

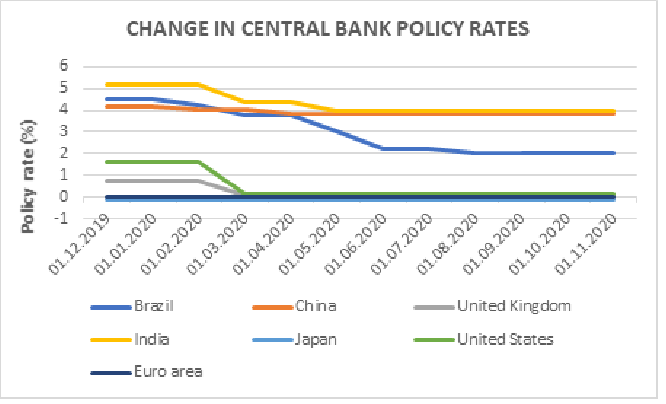

Figure 2. Change in central bank policy rates in 2020 (Source: TPO research team)

This has led to QE (unconventional monetary policy) becoming the default tool of central banks and in turn provided direct and indirect support for asset prices. The direct support coming in the form of purchasing sovereign debt (the Bank of England now own c. 30% of outstanding UK Gilt issuances) and indirectly through providing liquidity to financial markets which has been positively correlated with equity prices (Figure 3).

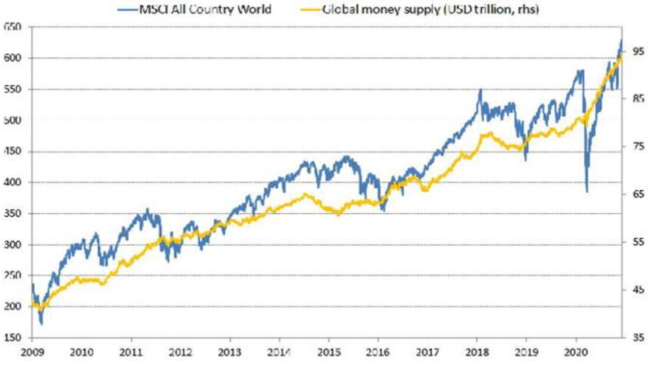

Figure 3. Correlation between global equities and the global money supply

Historically we have never seen this mass expansion in central bank balance sheets and public debt, however we must consider the ramifications of reducing stimulus measures now (rising unemployment, prolonged recession etc). We therefore expect policy makers to continue in the same manner and to provide a backstop to markets until there is a material improvement in economic conditions.

3. INFLATION

Aggressive easing of monetary policy, historically high debt loads and forward guidance from central banks explicitly stating they were happy for inflation to overshoot had led to concerns that high inflation was on the horizon.

The high inflationary environment of the 1970s has not materialised and instead we have seen a modest increase in inflation and expectations. This is expected to be transitory and remain low as structural themes of digitalisation, automation and high unemployment continue to be a headwind to inflation over the long term.

Future increases in inflation may be treated by the market as a 'scare' and expectations may increase but so long as these structural themes hold sway then the expectation is that inflation will remain below central bank targets until 2022 Q4.

4. VALUATIONS

Supportive policies and optimism that a vaccine would allow the global economy to reopen saw equity markets rally in late March and the COVID-19 market fall out become the shortest technical recession for the S&P 500 lasting just 117 trading days (Figure 4).

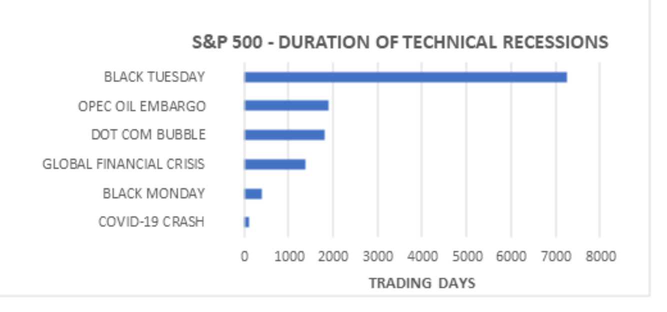

Figure 4. Duration of recessions in the S&P 500 following an adverse market event (Source: TPO research team)

This rally though was not a cyclical broad-based recovery as we saw technology stocks rally whereas the energy sector which had suffered from a fall in demand and a supply glut which led to a barrel of West Texas Intermediate falling into negative territory in April (Figure 5).

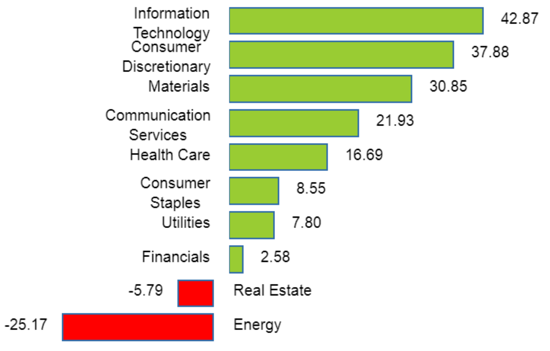

Figure 5. Sector performance of the MSCI World index in 2020 (Source: Factset)

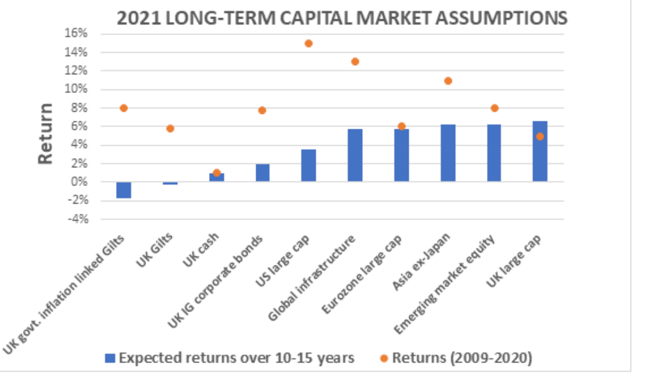

Figure 6. 2021 Long Term Capital Market expected returns (10-15yrs) (Source: JP Morgan)

This has led to historically high valuations. Using the forward P/E ratio as a measure of value, we can see that this is led by the US with valuations at their highest value in the last fifteen years – this is not entirely surprising though when you consider that heavyweight technology companies (Facebook, Amazon, Tesla etc) are listed in the US.

Other countries are trading at somewhat less frothy valuations than the US, but they are similarly at fifteen-year highs which when you consider the uncertain outlook and lack of hard recovery does pose questions.

The performance of global bonds though has been flat since the middle of 2020 and we have not seen the same level of divergence as we have in equity markets. Central bank purchases of sovereign debt have led to yields falling to historic lows. With Corporate bonds the chase for yield has caused credit spreads to fall to pre-pandemic lows - this can be interpreted as investors being happy to take the same return now, irrespective of the build-up in debt caused by the pandemic and the associated risks.

5. EXPECTED RETURNS

Returns are expected to be lower over the next 10-15 years with the primary catalyst being the present valuations (Figure 6).

Specifically, bonds and money markets are expected to underperform (UK inflation linked government bonds averaged 8% per annum since 2009 and now expected to lose c. 2% per annum over the next 10-15 years). On the equity side UK large cap equities are expected to be one of the better performing sectors (owing to recent valuations vs global peers) with Asia and Emerging Markets leading the way with a 6% expected annualised return (2% higher than the expected return of US large cap equities).

Forecasts in this environment will inherently be challenging, so there is a degree of variability in expected returns however our base case (at a broad market level) is that returns over the next 10-15 years will be lower than the returns achieved over the preceding 10-15 years.

SUMMARY

Economic recovery will be largely dependent on the effectiveness and take-up of the vaccines versus the accelerated spread of COVID-19.

- Expansionary monetary and fiscal policies are key to support economic activity and could remain longer than the pandemic.
- Modest inflation increase expected but persistent unemployment will keep inflationary expectations under control.
- Policy support, modest inflation and increase in economic activity should be positive for equity prices in a world where interest rates remain low.
- Bond yields near historic lows but supported by policy. Any 'inflation scare' leading to higher yields would be negative for bond returns.
- Further market stress will likely see capital flow to government debt as a 'safe haven' asset.
- Incidences of defaults in the corporate debt market could challenge the ability of central banks to support financial markets.

TPO Portfolio Performance

Portfolio(s)	01/12/20 - 31/12/20 (%)	31/12/15 - 31/12/20 (%)
	Dec-20	5 Years
ARC Sterling Cautious	1.50%	19.87%
Managed I	1.49%	27.78%
Passive I	1.07%	44.25%
ESG I	1.79%	47.70%
ARC Sterling Balanced Asset	2.10%	28.85%
Managed II	2.27%	37.45%
Passive II	1.43%	53.91%
ESG II	2.24%	56.92%
ARC Sterling Steady Growth	2.50%	38.87%
Managed III	2.51%	43.95%
Passive III	1.54%	52.56%
ESG III	2.61%	70.10%
ARC Sterling Equity Risk	2.80%	47.11%
Managed IV	3.13%	71.89%
Passive IV	1.99%	63.15%
ESG IV	2.73%	87.72%

Figure 7. TPO portfolio performance for December (Source: FE Analytics)

It was a good end to the year for our portfolios with positive returns across the board. Good news on the vaccine rollout saw risk-assets rally in December. The standout performer was the Managed IV portfolio which was up 3.10% in December. Portfolios were also supported by the news of a resolution to Brexit which saw UK equities rally. Particularly the smaller companies space where we saw our holding in TB Amati UK Smaller Companies fund rise 10% in December. Our portfolios are diversified and designed for the long-term. We are conscious that challenges and uncertainties do exist as we enter 2021 and this could cause volatility but with a long-term view this should create opportunities for the patient investor.

Our Investment commentary is not designed as specific individual advice, and should you have any questions or concerns please do contact your TPO adviser or contact us via the website, email or telephone. More information can be found at www.theprivateoffice.com.

This Market update is for general information only, does not constitute individual advice and should not be used to inform financial decisions. Most importantly, investment returns are not guaranteed, and you may get back less than originally invested; past performance is not a guide to future returns.