Investment*Insights*

Issue 26 — Fourth quarter 2020

How high can they go?

Stock markets have defied gravity this year, raising concerns that they have become disconnected from the realities of the economic recovery

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Rathbones
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Foreword

As COVID-19 continues to affect our lives and influence economic activity around the world, there's lots of uncertainty about what the future holds. Localised outbreaks and lockdowns are possible anywhere until a vaccine is found, with the level of unemployment likely to be the key factor driving the pace of the recovery over the next couple of years.

Economic weakness is likely to continue into next year, with the most optimistic forecasts for global growth still well below pre-pandemic levels. Our first article on page 3 examines the contrast between the macroeconomic environment and company earnings expectations, which remain surprisingly high for 2021.

On page 5, we explore whether emerging market debt is now being perceived as less risky. Unprecedented economic conditions mean many developing regions have been able to take potentially inflationary emergency measures without being punished by investors. Could this mark a paradigm shift for the developing world?

In a recent statement, the US Federal Reserve (Fed) indicated it will not raise interest rates until inflation has stayed above 2% "for some time". The shift, which we discuss on page 6, suggests rates are likely to remain low for a long time. We consider whether such measures could unleash rampant inflation, as feared by some investors.

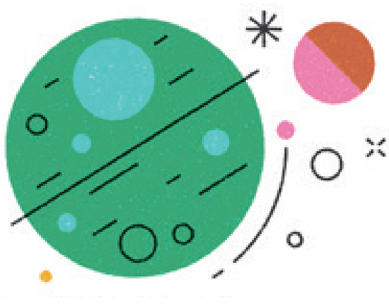
On page 8, we explore the growing popularity of specialist ETFs that are tapping into global mega trends. These funds adopt passive or rules-based guidelines to invest in equities that provide exposure to these themes. Although this type of investing can be successful as a long-term strategy, it's always important to do your homework.

Lastly, we take a closer look at how an increasing number of corporate bonds are falling down the ratings scale as default rates rise. Following the global economic lockdown in March, ratings agencies responded with a wave of downgrades — but should investors be worried?

I hope you and your family remain healthy and safe. I'd also like to reassure you that we're doing everything we can at Rathbones to keep track of what remains a rapidly evolving investment environment. Please visit rathbones.com to find out more about our latest views.

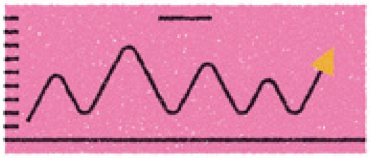
Julian

Julian Chillingworth
Chief Investment Officer



Will equities struggle to reach new highs as the economy recovers?

Global earnings expectations seem unreasonably high for 2021, despite the distinct possibility of continued economic weakness into next year. The most optimistic forecasts for global economic growth would still put the world's GDP about 3–4% below pre-pandemic levels.



That would be on the more severe side of a 'normal' recession – one that isn't precipitated by a financial crisis – and akin to the downturn of the early 1990s. This macroeconomic picture is greatly at odds with expectations for listed companies' earnings, what's called microeconomics in the trade. According to consensus estimates, profits are set to soar next year, partly due to the extremely depressed levels seen this year.

The initial economic recovery has been much better than people had expected when we were in the midst of the second-quarter lows. The Citi Economic Surprise Index is a measure of how actual economic data readings match up with analysts' expectations. As you can see from figure 1, US data has posted the greatest run of positive surprises on record – by quite some margin. And the picture is the same in the UK and Europe.

Riskier assets, such as stocks and corporate bonds, tend to move with macroeconomic surprises, so this no doubt helped spur stocks higher over the summer. Yet these surprises tend to mean revert – forecasts catch up with reality as expectations are revised – and this alone could remove a short-term driver of returns. On top of that, there is huge scope for economic data to disappoint in the months ahead. Leading economic indicators already suggest the stellar run for stocks may soon moderate as support programmes roll off and confidence slides.

If analysts' earnings forecasts come to fruition, next year's profits will be higher than they were in 2019 for every sector of stocks bar finance and real estate. We are sceptical that earnings can recover so far so quickly, especially in some of the more beaten-up areas of the market (figure 2). It is hugely uncertain how this unprecedented recession will play out, increasing the risks to profits, in our view.

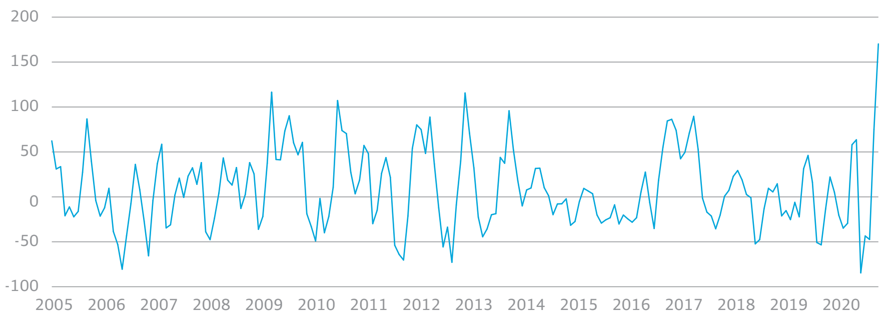
Running out of steam

There are already some signs that the initial recovery may be running out of steam, especially in Europe. In July, retail sales growth contracted in many developed and emerging markets. Global surveys of business confidence confirm a slower pace of improvement and in many economies, manufacturing barometers have fallen back to levels that suggest output is falling again, even though industrial production is still more than 10% below pre-COVID levels. Ordinarily, these manufacturing surveys would send persistently positive signals for many months after their recessionary lows. Meanwhile, household confidence – even in the US where the recovery has been relatively strong – has barely budged from April lows. Among those with lower incomes cohorts, the mood reached new lows in August. This isn't quite enough data to firmly conclude a change in trend, but it's enough to make us cautious.

Unemployment continues to be the biggest risk, in our view. This figure holds the key to recoveries because it colours the mood of the whole economy. When unemployment is high, people are wary of spending in case they get the chop next. They put off big purchases, like upgrading the fridge or the home it goes in, and worry about spending on the little stuff, like going to the cinema or buying fancier food for dinner. All of those individual decisions add up to less business for companies, which then cut projects and jobs to protect

Figure 1: US Citi Economic Surprise Index (%)

This measure of how actual economic data readings match up with analysts' expectations shows US data has posted the greatest run of positive surprises on record.



Source: Refinitiv.

profits. That works in reverse, too. When unemployment starts to fall it kickstarts a wave of spending and demand for goods and services that drives economic growth, encourages businesses to expand and reinforces the confidence of households.

UK unemployment has remained artificially low because of the furlough scheme. US unemployment gives a clearer picture, however. The jobless rate fell quickly from a peak rate of 14.7% in April to 8.4% in August. Excluding those labelling themselves 'temporarily unemployed', however, unemployment is still creeping up. If a large chunk of these people end up unemployed for more than six months, then history suggests they may find it difficult to ever find a new job, which would be a headwind to the ongoing recovery. This isn't solely a low-wage phenomenon either: unemployment in finance and IT is still roughly as high as during the global financial crisis.

Historically, stock markets recover from recessions when unemployment is still high. That's because markets anticipate the green shoots that are about to break surface and – crucially – they assume that unemployment will start to fall in a linear and consistent manner, as it invariably has in the past. But it is conceivable that unemployment may get stuck this time or start to increase again in the fourth quarter as temporarily laid off or furloughed staff end up not getting re-employed.

Risk of a second wave

Markets have proved relatively resilient in the face of a severe 'second wave' of COVID-19. That's because the rate of hospitalisation and, particularly, deaths has remained lower than during the initial outbreaks. Better treatment and a younger age profile of cases have allowed governments to refrain from redeploying the most stringent lockdown measures.

Whether this can continue into the winter is unclear, however. The highly contagious virus is stubbornly difficult to contain, so is likely to dampen economic activity – and therefore employment prospects – for some time yet, even though there really is a long way to go to get back to where the world was at the turn of 2020. It seems most likely that governments will persevere with a sort of 'whack-a-mole' approach of localised restrictions, rather than resort to second nationwide lockdowns. If we're correct, that means the chance of another Jules Verne-like plunge in global GDP is remote.

We believe the situation warrants a bias towards 'growth' businesses, which are less reliant on improving GDP for their profits, and 'quality' companies, whose earnings vary less than the average from one year to the next. These companies won't benefit as much from a surprise improvement in the global economy, yet they should be more resilient to disappointments. They also tend to hold less debt relative to their profits, which insulates them from increasing bankruptcies and the rise in borrowing costs that usually accompanies them.

But what if it all goes horribly right?

The truly unimaginable scale of public sector support has kept unemployment and business defaults from ever getting near the horrendous expectations of analysts when lockdowns first loomed. Financial stresses were contained, leaving borrowing rates and bankruptcies nowhere near where they were in the last crisis.

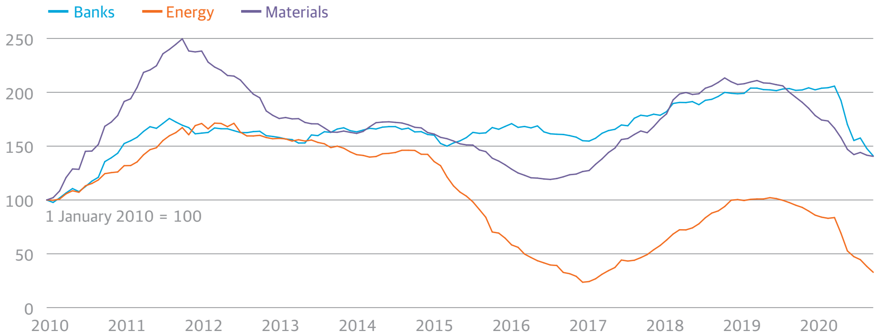
It may just be that we're being way too cautious. It may turn out that the astronomic injections of cash by central banks, the sacks of loans, guarantees and waived and deferred taxes will help businesses and households power out of this downturn like never before. As we've said many times, this situation and the responses to it are unprecedented. No one knows for sure how this will play out over the coming months and years.

Companies have been given tax breaks and wage subsidies and essentially free money to stay afloat. Many American households were given more cash during pandemic-induced unemployment than when they were employed and people weren't allowed to evict tenants. Essentially, in many countries, all the bad stuff and panicking wasn't allowed to happen.

With the Fed's recent adoption of a more flexible inflation targeting framework, and the continued ultra-dovish stance of other major central banks, there could be yet more monetary policy stimulus coming down the pipe. Contrary to what you may assume, the Fed's Congress-approved business support packages have hardly been touched, so there's plenty of help out there. The amount of policy space available should be supportive of the equity markets even if the economic environment deteriorated again.

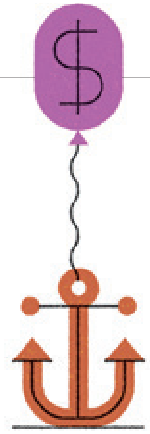
Figure 2: Earnings have taken a hit

Earnings in the banks, energy and materials sectors have been some of the hardest hit during the pandemic.



Source: Refinitiv; trailing 12-month growth in earnings per share, MSCI World sectors.

Past performance is not a reliable indicator of future performance.



Emerging market debt looks less risky with inflation under control

Since forever, global investors have been extremely wary of inflation in emerging markets. But the economic effects of the pandemic were so unprecedented that many developing nations have been able to take potentially inflationary emergency measures without being punished by investors (figure 3). Some emerging market central banks have even managed the previously unthinkable – quantitative easing (QE) – and still inflation expectations have generally stayed anchored. This could be a paradigm shift for the developing world.

The reason fixed income investors are more sensitive to inflation than stock market investors is right there in the name. A company can raise prices and increase their profits in line with higher inflation, so stock prices tend to hold their value when inflation rises (except in periods of runaway inflation). But when you have signed up to receive a fixed income – set coupons each year and your capital back at the end of the bond's term – any deterioration in the value of those payments (inflation) comes straight out of your pocket.

During the initial pandemic sell-off, investors ran the typical playbook. As the dollar jumped relative to developing currencies, money rushed out of emerging bond markets. But investors have returned much quicker than during past crises, helping most emerging market bonds recover, near enough, to their pre-pandemic levels. Currencies have recovered too, yet remain lower than before the crisis.

This bond market resilience has kept a lid on the borrowing costs for developing governments, allowing them to issue more debt in order to increase government spending to cushion the impact of the pandemic on their economies. In the past, bond investors have been much too flighty for emerging economies to embark on this 'countercyclical' spending in a downturn. In advanced economies, countercyclical spending is a standard response to recession, as it helps reduce the slump in GDP and eases the financial strain on people and businesses.

Are inflationary risks receding?

It's unclear exactly why investors are disregarding inflationary risks in emerging markets today. Certainly, the risk appears to have receded all over the world, driven by ageing demographics, the cost-cutting nature of technological progress and the effect of greater savings piles. Another reason is that many emerging market central banks took a lead from their developed world counterparts and stepped in as buyers of last resort during the initial sell-offs. Essentially a short-term QE programme, this would have been unthinkable even 12 months ago. It made it easier to sell emerging market bonds, potentially soothing fears that investors would be stuck with bonds nobody wanted.

Emerging markets' debts, relative to the size of their economies, have increased modestly because of greater government spending and falling tax revenues. Yet nowhere near the degree seen in the developed world. The spending is still substantial, however, so it should reduce the depth of GDP falls that would otherwise be the case. Emerging markets should also benefit from the extraordinary amount of money pumped into global markets by the Fed, European Central Bank and Bank of Japan. As yields fall in developed markets, more investors are pushed into riskier assets – such as emerging markets – in order to achieve their required returns.

So is emerging market debt less risky? In some ways, investors have already anointed the market less risky by not fleeing as they would have in the past. But as we pointed out, part of that is due to the distortions of central banks. There are still a lot of risks in emerging markets due to their generally less stable institutions, governance and currencies. Yet if they really have got inflation under control, they are now able to use countercyclical spending in downturns, meaning they should grow more smoothly. That would be good for investors as well as the emerging nations themselves.

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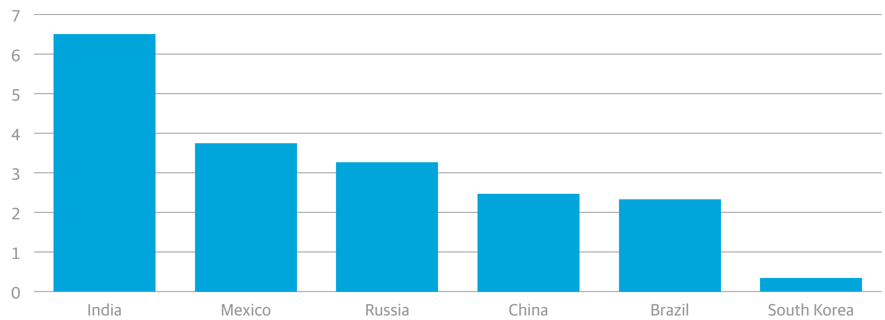
Figure 3: Annual change in inflation in selected emerging markets (CPI, %)

The effects of the pandemic mean emerging markets have been able to implement inflationary measures without spooking investors.



Source: Refinitiv.

What a more flexible Fed means for investors everywhere

The Fed, America's central bank, has a dual mandate, to maintain stable prices for the goods and services that households want to purchase, and promote maximum employment, which means that everyone who wants a job can get one. Congress formalised this mandate in 1977, but the Fed has been guided by it since the 1946 Employment Act, passed to help ensure Americans were rewarded for their efforts during World War II with a good standard of living.

This August, Fed governors made a once-in-a-generation change to the way in which they interpret this mandate, and the strategy with which they will pursue its goals. We had been anticipating part of the change since the Fed started dropping hints in the summer of 2019 (and so had the market in recent months), but the new statement means that interest rates will likely stay very, very low for even longer than previously thought acceptable.

Why did anything need to change?

The Fed's transparent inflation-targeting framework as we know it today was established for the most part in the 1990s. Since then, the Fed has observed that:

– potential economic growth has declined significantly, particularly trend productivity growth, which has more than halved since the late 1990s;
– the neutral real interest – the rate consistent with the economy operating at full strength and with stable inflation, and not directly affected by monetary policy – has fallen with it;
– despite extremely low unemployment, inflation has been stubbornly low over the last business cycle (figure 4); and
– global disinflationary pressures and low longer-term inflation expectations, an important driver of actual inflation, may have been holding down inflation more than was generally realised.

Those observations are a big problem for policymakers. Inflation that runs persistently below its desired level can lead to a fall in longer-term inflation expectations, which, in turn, can pull actual inflation even lower, resulting in an adverse cycle of ever-lower inflation and inflation expectations. If inflation expectations fell persistently, interest rates would decline in tandem, and with interest rates already low the Fed would have less scope to cut interest rates to boost employment during an economic downturn, which could further lower expectations and trigger a vicious circle.

In other words, the Fed doesn't want to fall into the trap Japanese policymakers found themselves in during the 1990s. Of course, central banks have developed new tools to fight deflation when interest rates are near zero, such as using their balance sheet to buy bonds (quantitative easing). Over the last decade these extraordinary measures have been very effective, but Fed staff are the first to admit that they aren't entirely clear how. Far better to try to engineer a situation in which there is less recourse to them.

A more flexible approach

So, what have they done? They have adopted a flexible average inflation targeting (AIT) framework. The Fed still wants to facilitate a 2% annual rate of inflation, but on average, not necessarily year after year. Following periods when inflation has been running below 2%, which have become uncomfortably common, monetary policy will aim to achieve inflation moderately above 2% for some time in order to make up for the shortfall. Note the asymmetry. If inflation averages above 2% for some time they will not target below-2% inflation to bring down the average. They've given themselves plenty of leeway: details of the "make-up" period have been left out of the policy statement. A chart that the Fed used last year indicates what this could mean for the path of policy rates: in mid-2019, interest rates were 2.25%, but if the Fed had been following a rules-based form of AIT, interest rates should have been 0.1% instead.

On employment, the revised statement emphasises that "maximum employment is a broad-based and

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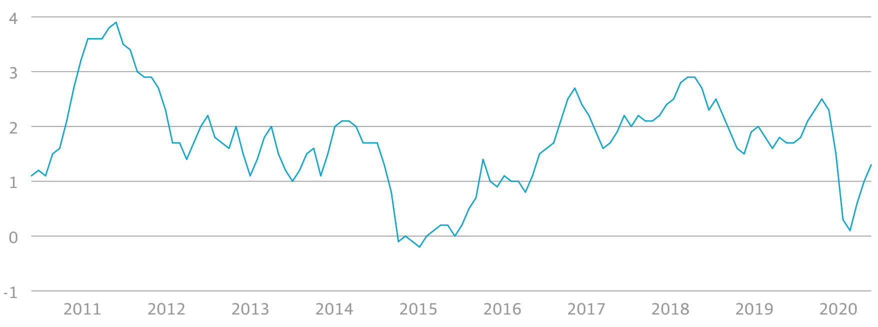
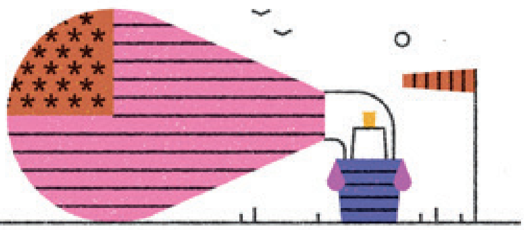
Figure 4: Low inflation has become the norm (US CPI, %)

Despite extremely low unemployment, US inflation has been stubbornly low over the last business cycle.



Source: Refinitiv.



inclusive goal" and "the benefits of a strong labour market, particularly for many in low- and moderate-income communities." We note asymmetry here too. They are now driven by "shortfalls of employment from its maximum level" rather than by "deviations". In other words, because the Phillips curve (the relationship between unemployment and inflation) appears to have flattened considerably, the Fed will no longer necessarily tighten rates when unemployment is back to normal, because there is evidence that this would mean women or minority communities may miss out on employment gains.

We note one more change that few people seem to be talking about. The new statement explicitly addresses financial stability and elevates it in the hierarchy of the Fed's goals. That's because long expansions, fuelled by low interest rates, are more likely to result in destabilising pockets of financial largesse. This change signals that the Fed will likely make more use of so-called macroprudential policy tools (eg, minimum capital requirements for commercial banks and similar restrictions).

While most investors accept that we are never returning to the lackadaisical days of pre-crisis regulation, we have been doubtful for some time that many really appreciate that regulation is likely to get tougher still. In our opinion, a better buttressed financial system is no bad thing when the greatest threat to investment returns is a deep balance-sheet recession. In capitalism's "golden age" of 1948–72, economic growth was so strong because there was no deep recession, in part achieved by institutional reforms which promoted financial stability and long-term thinking.

About more than money

Some investors are already worried that the extraordinary increase in money creation to fund stimulatory measures during the COVID economic shock will unleash rampant inflation. This dovish turn in the Fed's approach may alarm them further. We don't believe that sustained high inflation is a big risk, as we set out in a recent Investment*Update*. In short, the money supply has risen as part of the effort to plug a profoundly deflationary hole caused by this year's economic dislocation and the increased desire to hoard savings. But if inflation does start to rise, it will now have to last for a period of years before the Fed is prompted to try to curb it. And if rising inflation expectations start to push up longer-term borrowing costs, we may actually see the Fed respond with policy measures to push those costs back down so that they don't choke off the expansion before low-income households have participated in it.

It's also worth considering the inflation implications of any structural shifts that COVID might be a catalyst for. Most of the ones we can think of – for example, greater shifts from the physical to the digital economy or moves away from city-centre commercial real estate – are mildly disinflationary.

Taking all these factors together, we are more concerned about the risk that inflation remains stubbornly low than we are about it becoming intolerably high. Inflation is about more than central bank money. With spare capacity in the economy (figure 5) and incentives for companies and households to hoard cash, inflation should remain subdued.

This means any cyclical investments that tend to rely on rising yields, such as many banks or 'value' stocks, may be waiting a long time for any sustained outperformance. Meanwhile, an even longer period of repressed bond yields, which are used to discount company earnings into today's prices, helps support the high valuations of equities with strong growth credentials.

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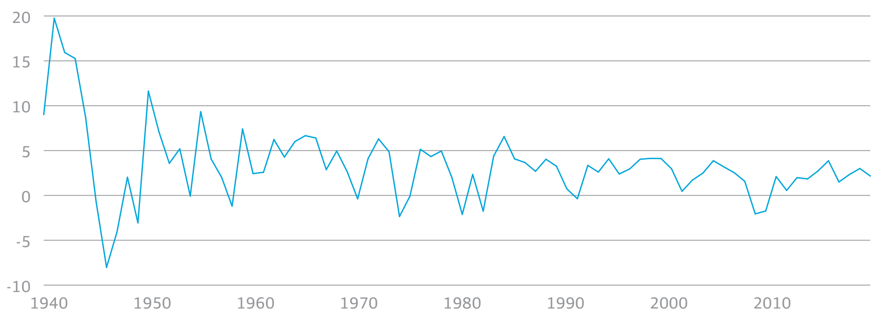
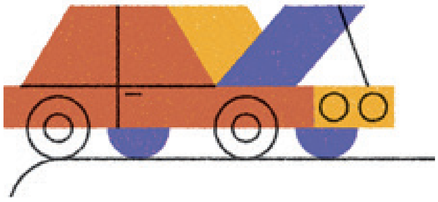
Figure 5: US GDP growth (%)

Some investors are concerned that the measures being introduced to stimulate the economy will unleash rampant inflation, but we think this is unlikely with growth remaining sub-par.



Source: Refinitiv.

Specialist ETFs offer unique opportunities and risks



This third article in our 'active versus passive' series makes the case for knowing what's under the bonnet before investing in innovative new ETFs.

Some specialist exchange-traded funds (ETFs) are all the rage at the moment, like 'working from home stocks' or Biden and Trump baskets, which select stocks according to whether they are likely to benefit from a victory by the respective candidate. But this approach could go wrong, which is why it's important to take a close look under the hood before investing in ETFs.

The humble ETF has come a long way since the first one launched in 1993. The essence of mimicking the investment return of an index is still present, but product engineering and entrepreneurial marketing have propelled ETF providers into innovative areas. Specialist ETFs tapping into global mega trends are growing in number and size, capturing the imagination of investors. These funds adopt passive or rules-based guidelines to invest in equities that provide exposure to these themes.

Many of these ideas have profited enormously this year from changing habits brought about by the pandemic – including new technologies and software that helps us work from home and medical innovation as more capital is made available to find a COVID-19 vaccine. ETF providers have been quick to take advantage by launching new funds, giving investors ideas that they may not have thought about before with the aim of generating strong future returns (figure 6).

What's in a name?

Investors tend to appraise ETFs based on their ability to mimic an index, as well as cost. Is there anything we can learn by applying these principles to new ideas? In the first instance, what these new ETFs are tracking is not always straightforward. Well-established indices such as the FTSE 100 or S&P 500 are large, transparent and independent from ETF providers, and criteria for inclusion are well understood.

In contrast, many newer ideas use proprietary measures for stock selection, which can blend objective and subjective criteria. These can make new ETFs difficult to understand and introduce unintended exposures into an investor's portfolio. Not all ETFs are the same, but some can be concentrated in fewer names, have exposure to less liquid smaller businesses or hold unprofitable companies. This approach can make the investment more risky.

The subjective element to security allocation is arguably an active decision but can also cloud exposures. Investment themes often comprise different industries, but fund providers might also select companies that benefit from trends rather than drive them. For example, e-commerce companies might feature in robotic and automation ETFs, which could introduce other stocks to the fund that are more sensitive to economic cycles. Some cybersecurity ETFs hold companies that specialise in other areas like defence. So pure-plays on specific themes and trends might not be easy to identify, or indeed gain exposure to without incorporating other, unrelated risks.

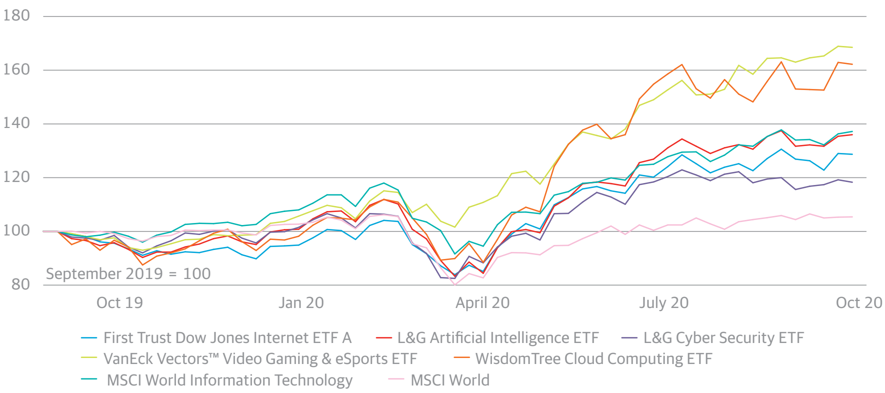
ETFs are usually cheaper to invest in than active funds, with the annual fees on many regional passive funds costing just 0.05% to 0.2%. Thematic ETFs can also boast a lower average cost relative to active funds. However, the cost advantages can be eroded by their propensity to invest in harder-to-trade smaller companies and in some cases rules that can generate higher trading costs, such as the requirement to have an equal weight in all holdings. Many of these strategies have performed well over the short term owing to the global health crisis, but it is hard to know whether they have long-term appeal. It can also be tricky for investors to allocate between the different trends and keep track of all the risks.

The law of averages suggests that if you invest in lots of different ETFs, some will perform well. Active managers can allocate capital in a risk-aware manner that blends the investment thesis of a company and a top-down theme. This approach can help active funds generate better returns when adjusted for risk.

Thematic investing as a long-term investment strategy can be successful, and investors should not discount new ETFs immediately. But it's important to do your homework so you know what's on the inside.

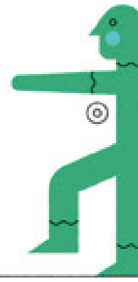
Figure 6: Investment growth in ETFs

Innovative new ETFs have been growing in popularity, thanks in part to the changing habits brought about by the pandemic.



Source: Morningstar.

Past performance is not a reliable indicator of future performance.



Deteriorating credit ratings are a concern for fixed income investors

An increasing number of corporate bonds are falling down the ratings scale, and default rates are picking up. How many are on life support, just awaiting their ultimate demise, and should investors be worried?

As the global economy went into lockdown back in March, the ratings agencies responded with a wave of downgrades. The credit quality of the global corporate bond market as a whole fell the most it ever has since the birth of high yield (popularly known as junk) bonds in 1977.

Companies that were previously rated investment grade — household names like Ford, Renault, Rolls-Royce, Royal Caribbean, Kraft Heinz, British Airways, Marks & Spencer — are set to fall from grace in record numbers, tumbling over the cliff from BBB into BB, or junk territory. At the same time, the ranks of CCC-rated bonds, near the precipice of default, also swelled. To some degree, bond markets have priced in the risk of a second wave of the virus in these high yield bonds, but a lot of uncertainty remains about how high default rates will go and for how long (figure 7).

In the US high yield market, default rates reached 6.3% in August, up from 2.9% before the pandemic struck. Clearly lockdowns and continued social distancing have hurt some industries more than others. Ratings downgrades have mainly hit the leisure, transportation, retail and energy sectors, and have been less pronounced in more defensive industries like healthcare, telecoms and media.

These downgrades have swelled the ranks of companies rated B- and lower, which now account for roughly a third of all high yield debt. Companies with a B rating are generally considered to have the capacity to repay creditors, but adverse economic conditions could impair their ability or willingness to do so. Once they fall from this perch, they are seen as vulnerable and dependent on favourable conditions to meet their obligations. It goes without saying that in the current environment of economic uncertainty, this is not a safe place to be.

On negative watch

As economic activity improved into the second quarter, both actual ratings downgrades and the amount of debt on negative watch for potential downgrade slowed significantly. Generous and timely support from governments and central banks has lessened defaults over the near term, but all support to date adds to existing debt piles at a time when basic revenue is lacking. This could lead to a more prolonged period of higher defaults than would be the case in a typical recession and recovery cycle.

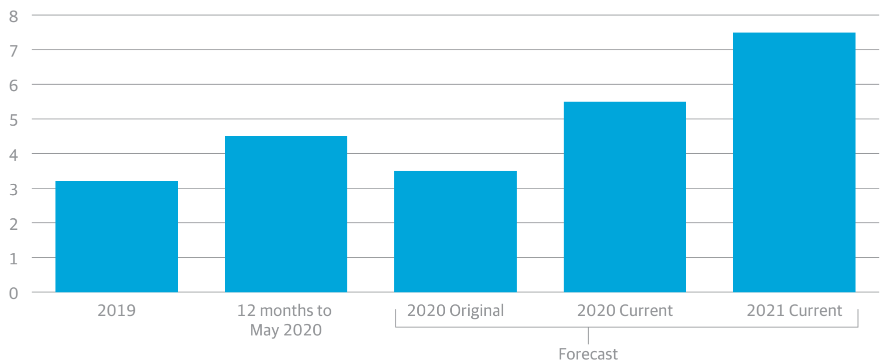
Our view is that the risk of a more drawn-out period of higher defaults will remain as long as the world is still waiting for a COVID-19 vaccine, and that most of the hard-hit sectors are likely to continue to see further downgrades over the next 12 months. The ratings agency S&P estimates that default rates will rise to 12.5% for US high yield issuers by March 2021.

The key question now is what's already priced in? Generally speaking, valuations have risen a lot from their March trough, when the additional yield that investors were demanding for investing in US high yield was a massive 10.9 percentage points. That spread has since roughly halved to about 5.5 percentage points at the time of writing. But we shouldn't be fooled by the headlines. Overall spreads seem to be returning to more typical levels, but the pandemic has dealt a big blow to credit markets. US high yield spreads are still significantly above pre-crisis levels, as the credit quality of the whole sector has been dragged lower by the sheer volume of downgrades. The still-elevated spreads are in effect pricing in the risk of a potential second wave of coronavirus that could push default rates even higher and potentially for longer.

Until the pandemic is contained, social distancing and other restrictions will continue to delay the eventual recovery in default rates. There may well be some attractive opportunities among some issuers. But for high yield as a whole, the risk of higher defaults for longer seems to us to outweigh a bit of extra yield, even when bond yields in general seem to be going ever lower for ever longer.

Figure 7: Default rate forecasts (%)

Default rates have picked up during the coronavirus pandemic, and forecasts have been revised sharply higher through 2021.



Source: Fitch Ratings.

Financial markets

US stockmarkets had their best August since 1986. Fuelled by a rally in technology shares, and by quarterly earnings from companies that were more positive than had been expected, the S&P 500 and Nasdaq reached record highs. Tech giant Apple became the first US company to be valued at $2 trillion (about £1.5 trillion), though subsequently retreating amid general profit taking in tech shares in September.

During the sell-off, the share prices of Amazon, Alphabet, Facebook and Microsoft fell by more than 10% from their recent highs, while Apple's dropped by 16%. However, over the longer term these business are seen as attractive in a low-growth world and have benefited from the ways our lives have changed during the pandemic.

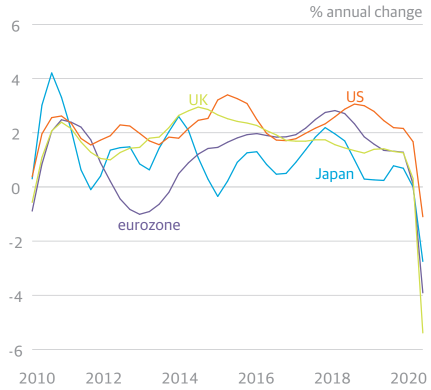
Bond yields fall to record lows

Government bond yields fell to record lows owing to central bank buying and the increased demand among investors for safe-haven assets. The Fed has indicated it will not raise interest rates until inflation has remained above 2% "for some time". This shift in policy suggests rates could well remain close to zero for several years. The ECB has also said it will no longer focus rigidly on keeping inflation below but close to 2%.

Gold hit $2,000 per troy ounce for the first time, driven by depressed bond yields and fears over the impact of COVID-19 on the global economy. Gold usually suffers a disadvantage relative to government bonds because it doesn't provide any income. However, many government bonds currently carry negative yields, meaning buyers are guaranteed a loss if they hold the debt to maturity. This has helped boost the appeal of gold.

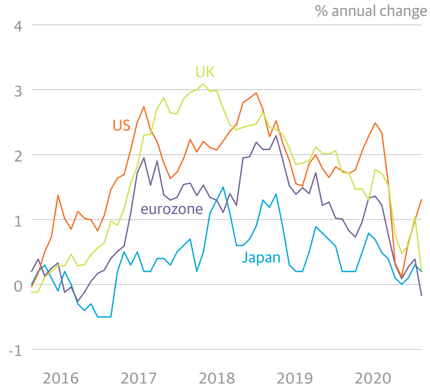
Although prices have now fallen back, gold can be a useful hedge in multi-asset portfolios against further uncertainty and ultra-low rates make it more attractive relative to other safe-haven assets like bonds.

GDP growth



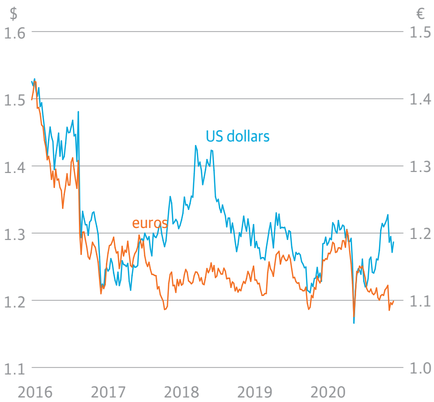
Source: Factset and Rathbones.

Inflation



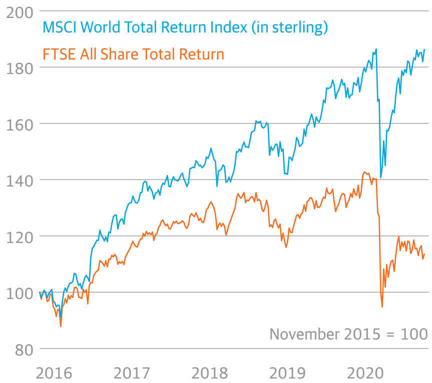
Source: Factset and Rathbones.

Sterling



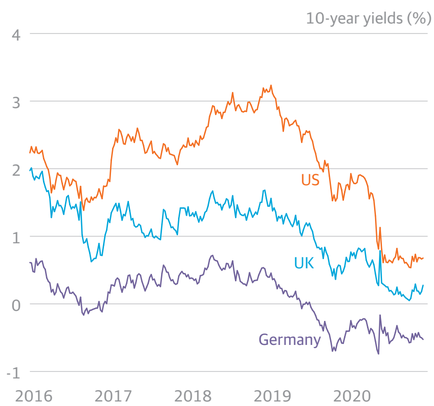
Source: Factset and Rathbones.

Equities



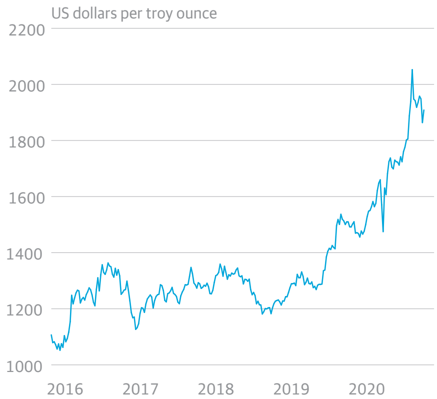
Source: Factset and Rathbones.

Government bonds



Source: Factset and Rathbones.

Gold



Source: Factset and Rathbones.

Past performance is not a reliable indicator of future performance.

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**Investments can go down as well as up and you could get back less than you invested.
Past performance is not a reliable indicator of future performance.**

Taking the next step

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rathboneimi.com

@Rathbones1742
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