020 3755 3235 or 01473 384858

contact@swallow-financial.co.uk

INVESTMENT NEWS

Investment Update January 2021

Welcome to our new year investment bulletin where we try and explain what is happening to markets and we confirm our views going forward.

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COVID PAST PRESENT AND FUTURE

It is astonishing how in such a short time our world has been thrown into turmoil by the Covid virus. 18 months ago, one would have discounted such predictions as scare mongering. We are now in the most severe lockdown yet, thousands are dying and our local NHS is a place you don't want to visit if you have any choice at all!

Covid dominates the international investment theme and may do so for some years to come.

Looking forward, if you can survive the current outbreak hope is on the horizon in the shape of the 3 approved vaccines. Whilst the elderly and vulnerable will hopefully be vaccinated by the end of the first quarter, it is going to take years before we have vaccine-assisted "herd immunity". The consensus seems to be that hopefully by the summer the lockdown can be lessened sufficiently for life to return to a new normal before new lockdowns in the winter of 2021/2022. Always being in mind of course that vaccinations will have to be updated before and during the winter of 2021/2022.

And finally, what of the mutations?

UK PLC

Brexit

Boris produced a trade deal like a "rabbit out of a hat" just before the deadline, just enough time to get it approved by the UK parliament whilst at the same time ensuring very little scrutiny of the "fine print". We expect many issues in the short term however longer term if we can keep away from the moribund ways of the common market, the UK should be able to thrive in a more open environment. The fear of course is that we keep or even increase the bureaucracy and lose many benefits.

Inflation

The latest UK CPI inflation we have is for November 2020 giving annual inflation of .55% (CPI) or .86% (RPI).

The BOE forecast for inflation is that it will return to close to the preferred rate of 2% by 2022/2023.

Right now (see our comments re debt and interest rates) a prolonged period of decent inflation would do wonders for the relative debt figures.

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Gross Domestic Product

Again, our GDP fell by 11% in 2020 (globally the figure was around 4%) which is catastrophic under normal circumstances. The BOE are optimistic of a 7% rise in 2022 (international bodies predict UK GDP rises are between 5% and 6%).

Interest Rates

UK Base Bank rates (and hence general interest rates) are likely to remain at the current levels for the foreseeable future, indeed a third of pundits (Thomson Reuters) believe we will see say 1/3 of a % reduction in the next 2 years.

The amount of government debt alone is a very good incentive to maintain the current zero interest policy.

Interestingly the risk margins have increased, those seeking 75% LTV mortgages are paying .5% more and those after a 90% advance are paying 1.65% more (BOE stats) than a few months ago. Very little unsecured debt is available suggesting that lenders are nervous going forward.

Government Debt

We are still in the sweet factory, spending, “Monetary Easing” and borrowing as if there is a bottomless pit of available debt. The figures are so big it is impossible to grasp. A bit like many consumers, however, the government point to the cost of funding the debt mountain which in the current interest rate environment is still quite manageable. June 2020 did however see the landmark of UK debt exceeding GDP for the first time.

Sooner or later the constant drug of Monetary Easing has to be turned off.

CASH

The BOE produce a record of Household sector cash in non-interest-bearing deposits. These have risen spectacularly over recent years. In 2007, cash nil rate deposits stood at around £20 billion they now stand at £225 billion.

BOE statistics also point to cash savings in 2020 being £111 billion (£45 billion in 2019). This explains the wall of cash that is available to push up asset prices when people feel more confident of the future.

The average instant access account now pays interest of 0.12%, well below even the current marginal inflation rate.

BONDS

10 year government bonds offered a return of 6.8% p.a. 20 years ago. Currently the return is 0.7%.

Bonds “defied gravity” again last year, managing to find some value increase in the market. They now look even more expensive than they looked previously and whilst we could be proved wrong, we prefer other asset classes including cash.

On the plus side, the two arch enemies of fixed interest investments (inflation and interest rates) look very subdued. The era of the zero-rate government bond is likely to be with us for several years to come. There is no “risk free” income.

COMMERCIAL PROPERTY

Investor demand remains subdued, though there were some signs of increased interest among overseas investors. Rental income for retail property remained significantly lower than a year ago, though it was slightly higher in the second quarter. Some landlords were reported to be considering repurposing retail premises. Office rental returns were reported to be only slightly below normal. However there remains significant uncertainty about the future as many people continue to work from home. Demand for industrial, distribution and logistics premises remained high.

During November, UK Property funds had net outflows of £147m. A significant proportion of the largest funds remain suspended. We are monitoring the unit value of property funds as they become unsuspended. The average fall in value is around 5% but that does hide significant variance between specific funds.

Commercial property funds are an excellent source of (relatively) low risk income generating assets. We don’t believe that office rentals will collapse. Retail shopping will change rather than cease to exist and pubs and restaurants will recover once COVID subsides.

CURRENCIES

A new president will typically lead to a fall in US Equites for the first few months and this combined with the high value of the Dollar suggests there will be some weakness in the dollar going forward. The pound may also be weak until there is more certainty with regard to the EU deal.

EQUITIES

Equity prices look expensive (although there is a great variance between geographical areas). Markets seem to have priced in the best of all Covid and economic recoveries. It is worth remembering the Monetary Policy Committee's comments in November:

> "The MPC judges that the outlooks for the UK and global economies are unusually uncertain at the moment."

This is reflected in the MPC forward projections which currently have a wide range of outcomes.

On the other hand, look at the cash mountain above, regardless of the valuations, supply and demand may well push up asset values significantly.

An interesting statistic from AJ Bell highlights the need for geographical spread:

	UK	US	EUROPE	JAPAN	OTHER
Typical Managed Fund	40.3%	27.7%	13.0%	5.3%	13.7%
MSCI World	3.7%	57.7%	12.9%	6.9%	18.8%
10 Year Total Return	77.3%	313.4%	119.5%	131.3%	

Whilst there will always be "home bias" this shows the in poor performance generated by sticking to conventions.

UK Equities

Only Russia and Brazil performed worse than the UK in 2020. This vindicates our asset allocation strategy which remained light UK throughout 2020. Coming into 2021, the UK market seems better value than most and as such worth a higher allocation.

Columbia Threadneedle suggests that the UK, pound-for-pound, are on double discounts compared with if they were quoted in Europe or the US, and an average of a 40% discount to the World MSCI.

One would expect volatility as we gradually get back to normal. We expect further setbacks with BREXIT to give short term issues. Foreign investment is likely to improve as outsiders perceive the BREXIT issue is over.

US Equities

The US market has had an amazing run due to its heavily growth orientated market. The relevant values make it expensive in the current marketplace. Where possible we would be light US equities and very light tech stock. With 57% of the world MSCI index, one cannot ignore the US market completely..

In 2020, the NASDAQ grew by 44%, the FTSE 100 fell by 14%. For those who believe in investment cycles, the Political Cycle (see our notes on Investment Cycles and Factor investing) further backs our bet that the US is due a poor year.

Asia

BMO highlight Asia as the market for 2021. They suggest Asia is generally further through the Pandemic and is better placed to kick start its recovery.

European Equities

Whilst we believe the longer-term outlook for the EU is poor, short term the valuations are reasonable in comparison with the rest of the world. Europe should benefit from sales of vaccines.

Emerging Markets

These were hit hard by the Pandemic, nonetheless, going forward their vibrancy and lack of social spending commitments puts them in a good (if volatile) place. Dollar weakness should help emerging markets recover.

China remains uncertain. Joe Biden's attitude to the current trade dispute could have an impact on returns. As could a backlash over working conditions and civil rights.

What Happened To Dividends?

FTSE dividends were 25% down in 2020, this is expected to largely recover in 2021.

PRECIOUS METALS

Despite the arguments that Gold and other precious metals are excellent long-term investments, we tend to use them as a hedge against equity and property falls.

Gold peaked @ 1,491 per oz on the 9th November and now stands at £1,364 per oz.

Silver has been incredibly volatile but peaked at £20.50 in December to now stand at £18.75 per oz.

Wherever possible, we hold physical metals rather than mining companies. This does remove some gearing from the returns but reflects our objectives for the product.

ASSET ALLOCATIONS

Commercial Property

Whilst we believe commercial property remains an excellent income generating long-term asset, we are nervous about the Covid fallout so have reduced the exposure we recommend from 17% to 15%.

We expect the suspensions to lift later this year. We further expect some intervention from the FCA to make redemptions more difficult. When the dust has settled and values are again correct, we will bring property back to 20% of an average portfolio.

Precious Metals

We have reduced our exposure to Gold and Silver to around 7.5% of our templates.

Value Funds

At its heart, value investing aims to cut through speculation about a company's prospects to look hard at the reality of the business and buy its shares if they are trading at a discount to their intrinsic worth.

In recent years, Value has lost out big time to Growth stock (and Tech in particular) however we believe the relative valuations mean we should increase our exposure to Value alternatives.

We have increased our exposure to Value stock both in the UK and internationally.

Large Tech Funds

The absolute stars of investment returns in recent years have been the big Tech companies collectively known as FAANGM (Facebook, Amazon, Apple, Netflix Google (Alphabet) and Microsoft.

We have been disinvesting from funds which highlight these shares (very difficult when they have 35% of the S&P 500 market cap) as we feel their success has led to high valuations. Indeed, they are the prime reason for the overpricing of US stock markets.

Large Companies

If we are returning to some kind of recovery, then we will be increasing our exposure to smaller and mid cap companies over the biggest businesses.

SUMMARY

If 2022 ends up as the year Covid is contained, then we can see excellent returns in Equities and a recovery in Commercial Property. Whilst prices may be high relative to where we are in the recovery, supply and demand suggests that prices will continue to rise. We believe the best approach is to selectively diversify clients' holdings so as to optimise returns in the years ahead.

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