Market Outlook

December 2020

Summary

- The second and third waves of coronavirus are a clear negative for economies and risky assets.
- Equally, the concept of “there is no alternative” (described below) and the longer run promise of the vaccine, are reasons to temper our bearishness.

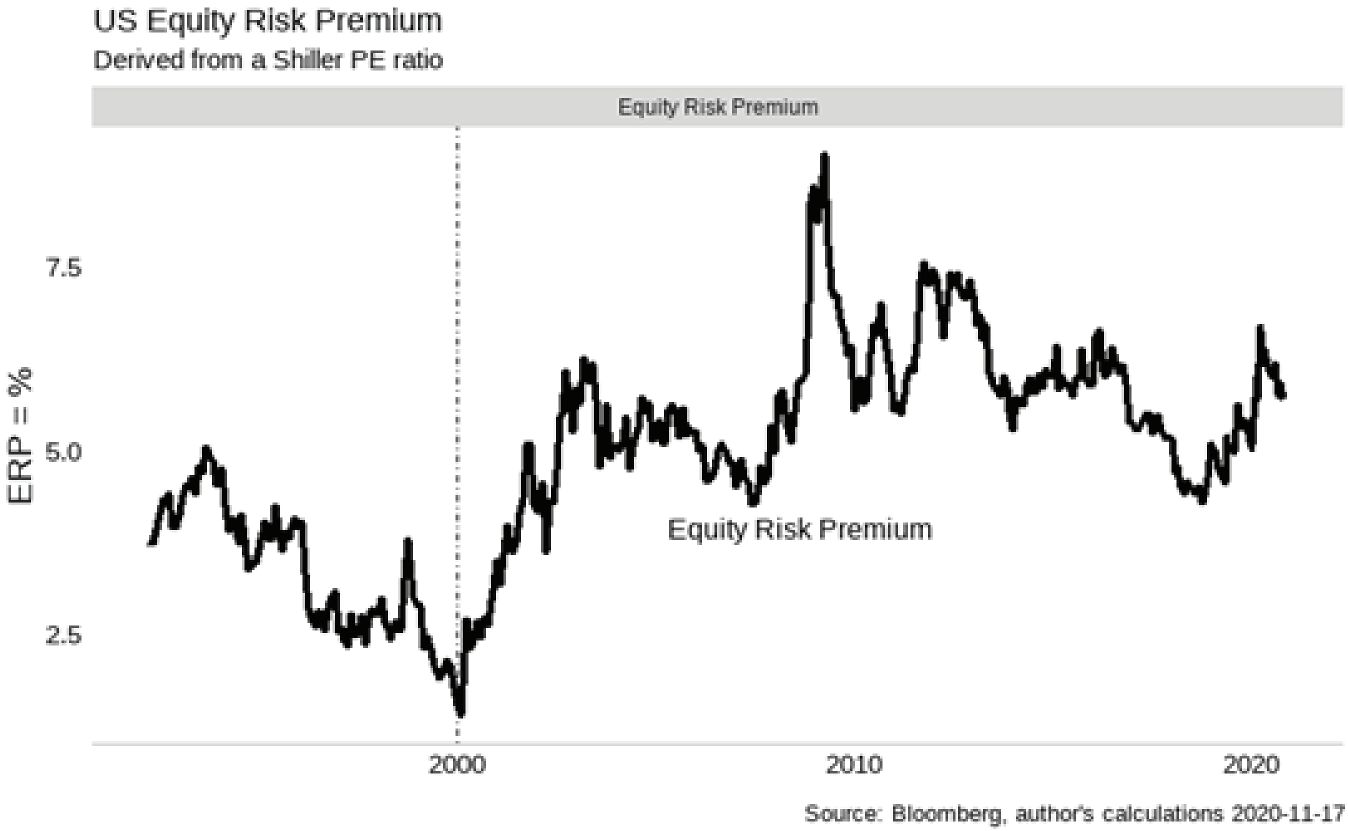
In this note, our final Market Outlook report for the calendar year, we discuss the strategic rationale behind an allocation to equities. This is instead of focusing on our more normal Dynamic Asset Allocation rationale, which is about whether we own a little more or a little less of equities over an economic cycle.

Commonwealth Private

Valuations

Equity Risk Premia (ERP, the extra return we expect from equities over safe assets in the long term) are still quite high, despite the rally in equity markets. The ERP are what drive the returns to shares over the very long run. It's a risk premium that accrues to equity holders in exchange for taking on solvency and bankruptcy risks (effectively, the risk of not getting your capital back).

Firstly, high ERPs are reason to put money to work in equities. Compare current levels to the late 1990s, when the ERP was less than 1% and, by way of opportunity cost, risk-free assets like US Treasuries were yielding close to 5%.



There is no alternative

Secondly, consider the alternative to equities. Real government bond yields are negative over a range of tenors, which is not an especially attractive alternative for capital deployment. This doesn't mean owning no bonds or no fixed income – these assets still have an essential role to play in a portfolio, because of the negative correlation to equity market risk (hence the "strategic" focus of this section). However, it does place a limit on the amount we'd deploy at the margin.

Even corporate credit, which contains an extra risk premium (a higher prospective return due to the possibility of bankruptcy, called the credit spread), offers little by way of additional yield. In fact, the yield that's left over once we adjust for the expected number of defaults suggest this Excess Bond Premium (EBP) is negative. This is not an especially attractive alternative either.

Corporate profit margins

Thirdly, coronavirus, even with a vaccine on the horizon, will have lasting effects on the labour market. It's likely this will translate into weaker bargaining power for employees, and in turn, will likely support corporate profit margins over the next few years. Given that pre-coronavirus unemployment rates of 3%+ were leading to wage gains and eroding profit margins, coronavirus – while not ideal from a societal perspective – is nonetheless a clear support for corporate valuations.

Monetary policy

Lastly, the mix of average inflation targeting, forward guidance, and Quantitative Easing employed by many central banks around the world, are all keeping the term structure of interest rates flat out until 2024-2025. And these are unambiguously friendly to risky assets.

Conclusion

Keeping this note deliberately high level, and abstracting away from much of the detail, we note:

- High Equity Risk Premia;
- Negative Excess Bond Premia;
- Elevated corporate profit margins;
- Combined effectiveness of monetary policy.

So our thoughts in summary are that valuations are elevated, macro-economic factors are on the whole mixed, and market sentiment is becoming elevated. These factors suggest we should retain a solid exposure to equities across our diversified investment portfolios in line with our long term strategic allocations, in order to achieve their respective return objectives.

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