



Investment Report – Q4 2020

“There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns - the ones we don't know we don't know.” Donald Rumsfeld, United States Secretary of Defence

We closed our last letter by saying that the final quarter of 2020 would bring with it three known unknowns: the terms of Brexit, vaccine trial data and the outcome of the US election. We hoped to have a resolution to most, if not all, of these matters by the end of the year. At the time of writing, we are pleased to have considerably more clarity on all these fronts, with the market reaction to each outcome having been broadly as we anticipated. Whilst 2021 will no doubt bring with it both of Mr Rumsfeld's unknowns, we believe that the structural views that benefitted our investment strategy in the last quarter stand us in good stead for the year ahead.

Having resisted the urge to comment at length on Brexit in our quarterly letters throughout 2020, we eventually saw the UK leave the European Union at the end of the year with a sufficiently comprehensive trade agreement to prevent a 'no deal' scenario, thereby providing relief to investors in UK assets and currency. We have long held the view that this middle ground would be found to protect the interests of both sides at the negotiating table and expect those negotiations to continue for years to come as arrangements for the UK service sector are finalised. As confidence in a benign outcome increased, the primary investor reaction took place in currency markets, with Sterling strengthening 6% against the US Dollar in Q4 as the risks associated with Brexit subsided. The corollary to this currency movement late in Q4 was a rally in the UK equity market, with companies and sectors that benefit from Sterling strength outperforming the wider market.

Given our preference for mid-cap and small-cap equities within our UK equity exposure, we were able to capture a good deal of this rally. Exhibiting both world-leading innovation and a source of value, the UK small-cap market performed particularly well in Q4. Notwithstanding this recent performance, UK companies have been weighed down by several years of capital withdrawal due to Brexit and regulatory pressures. The chart below highlights the performance disparity between UK equities and global equities since the Brexit referendum. With UK politics now on a steadier footing, we expect these equities to have greater appeal to both institutional investors and other corporates (leading to increased mergers and acquisitions), driving improved performance from the UK equity market in the years ahead.

FTSE All-Share Index versus MSCI World Index



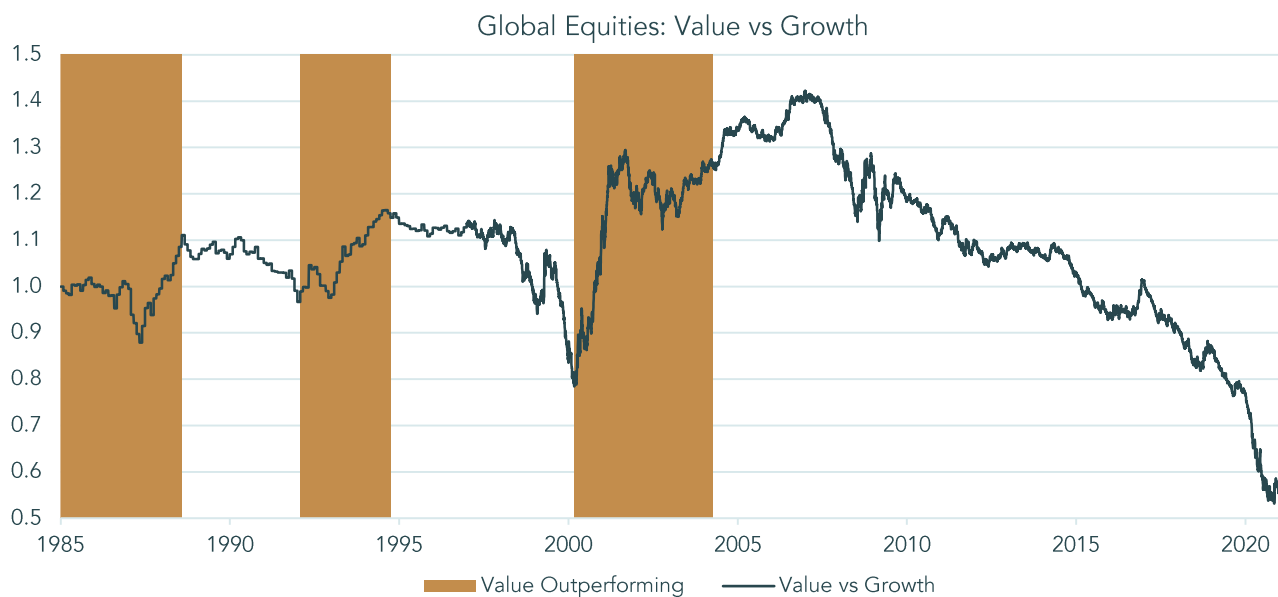
Source: Bloomberg LLP, 2021



Earlier in the quarter, the US electorate chose Joe Biden as its next president by a margin of 306 electoral college votes to Donald Trump's 232, with President-Elect Biden also claiming a majority share of the popular vote. The result represented a validation of the polling industry, with consensus predictions before election day proving to be broadly accurate. Whilst markets had moved to reflect forecasts of a blue White House before November 3rd, we saw a positive move in equity markets on the day as investors welcomed the certainty of a result. As expected, there was also a divergence in sector performance, with Biden-friendly sectors such as renewable energy and healthcare gaining ground, whilst sectors like oil and gas fell.

The early market moves following Joe Biden's victory were quickly overshadowed by an intense relief rally triggered by efficacy data from the world's major Covid-19 vaccine trials, leading global equities in November to deliver their best monthly return since 1987. Investors shifted capital away from popular 'momentum' trades into sectors that had been bruised by the pandemic, including airlines, hospitality, and banks, with the extent of the sector rotation on 9th November hitting multiple statistical records.

The weeks following the vaccine data and US election result proved to be an extremely supportive environment for some key themes running through client portfolios, including our preference for value-oriented equities in developed markets. We express this view via active managers in the UK, Europe, Japan and the US, which benefitted from the rally in previously unpopular companies with fundamentally strong balance sheets. However, the chart below shows that the outperformance of the value style of investing in late 2020 is negligible compared with the 14 years of outperformance of the growth style since 2007. We continue to hold our value tilt in developed markets in the belief that these equities are due a sustained period of outperformance, with supportive economic factors benefitting many value industries, as well as stretched valuations in many growth companies limiting their expected returns.



Source: Bloomberg LLP, 2021

Sticking with the near term, 2021's political narrative should prove eventful as markets digest the implications of a Biden presidency. Post quarter-end, it was confirmed that Georgia had elected two Democrat senators, thereby giving the Democrats control of both the Senate and the House of Representatives. This will allow the president-elect to pursue his more ambitious policies with less resistance from the legislature. US government bond yields rose in reaction to the news, as markets anticipated higher fiscal spending and more bond issuance, whilst some technology shares came under fresh scrutiny as investors speculated on a tighter regulatory environment for tech giants. The nomination of Janet Yellen for Treasury Secretary looks to be pivotal for both the US economy and financial markets, with her ability to influence economic policy magnified by the Democrat wins in Georgia. Whereas the nomination of Elizabeth Warren would no doubt have unsettled markets given her negative stance on free markets and financial services, investors will watch with interest as the agenda of a more centrist Treasury Secretary surfaces over the course of 2021.



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On the international stage, Joe Biden will inherit a handful of sensitive situations with the potential to move markets. Among them is the response to Russia's 'SolarWind' hack, a breach of national security that is reported to have begun as early as March 2020, going undetected until mid-December. The hack appears to have been carried out by the Russia's SVR, the Russian equivalent of the CIA. Whilst President Trump's national security council have held a string of briefings following the discovery, it will likely fall to the Biden administration to act on this transgression. The latter is likely to employ more conventional diplomatic channels than the Trump administration in its dealings with Russia and, crucially, China.

US relations with China were a constant feature of the Trump presidency and we expect no change on this score as Joe Biden takes office. Whilst Mr Biden is perceived to be more conciliatory than his predecessor, he has espoused Trump's notion of strategic rivalry with China, having publicly condemned various state actions in Hong Kong and Taiwan. Tensions will no doubt remain, but the injection of climate objectives into the bilateral relationship could mark an important difference between the Trump and Biden eras. The leader of the climate dialogue going forward will be John Kerry, who was able to draw China into a bilateral climate agreement in 2014, a precursor to the Paris climate accord. Xi Jinping has already recognised the need for joint action on climate, with multiple domestic comments on the matter since China's first commitment to net zero emissions in his speech at the UN in September. Biden's inherent focus on climate, coupled with John Kerry's diplomatic aptitude, could provide the basis for a more stable trading relationship which would be supportive for global growth. As a result, we expect the subject to be a focal point for markets in 2021.

As we turn the page on a challenging year, it is pleasing to see markets begin to move towards our way of thinking. Yields on benchmark government bonds rose over the course of Q4, eroding the capital value of these instruments which we avoided owning in client portfolios. The quarter also saw a sustained period of outperformance from unloved 'value' equities in developed markets, another tactical allocation we have held for some time. We are confident these themes and many others in client portfolios have plenty more runway ahead. Whilst 2021 begins with the scars of the previous year, financial markets will continue to look forward and perhaps we will see this decade continue to play out like the roaring 20s.

Fred Hervey
Chief Investment Officer