Investment Strategy Group
Investment Update

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To describe 2020 as an eventful year is clearly an understatement. What with a global pandemic and extraordinary mobility restrictions in an attempt to contain it; unparalleled policy stimulus to help offset one of the sharpest falls in economic activity on record; the fastest S&P 500 bear market in history followed by one of the most powerful recoveries; and the deployment of massive amounts of money and resources to find a medical solution to COVID-19; we think investors can be forgiven for feeling a little exhausted. But the year is not over and there is the potential for a few more surprises yet.

On a medium-term horizon, we maintain a reasonably constructive view towards equity markets, both domestically and abroad. In order to support economic recovery, policy makers have made it abundantly clear that they will maintain ultra-stimulatory policy conditions for some time yet. Central banks have driven interest rates to historic lows, and they look set to hold around these low levels for the foreseeable future. In fact, in the case of the Reserve Bank of New Zealand, there is now serious consideration being given to crossing the Rubicon and taking its policy rate (the Official Cash Rate) into negative territory. Governments all around the world have also leant on their large balance sheets and delivered significant amounts of stimulus, which also looks set to be maintained for a least the next few years – if not be ramped up further in the case of some countries.

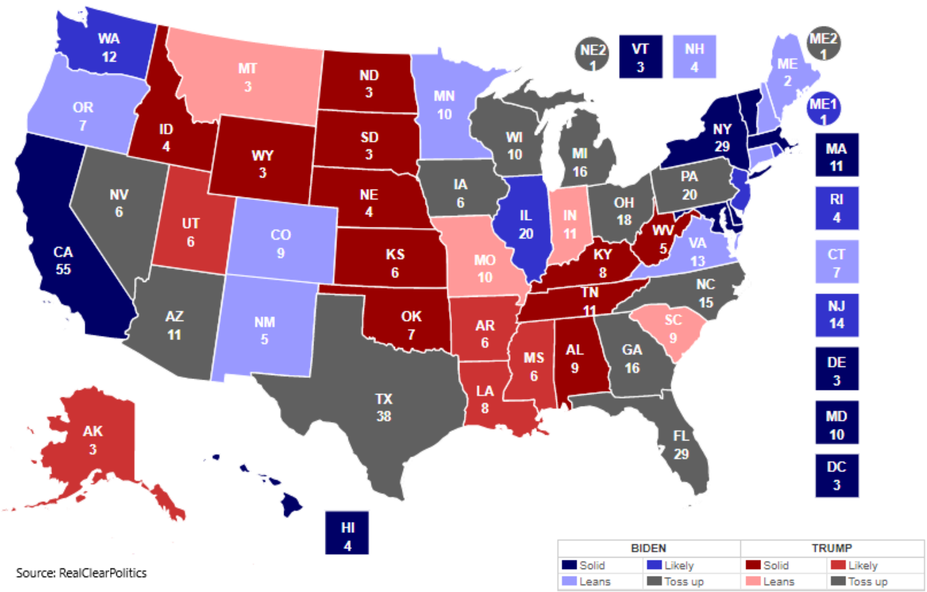
This policy stimulus has a powerful impact on financial markets. First, it has offset some of the significant economic damage that would have occurred in its absence and provided investors with the ability to more easily look through COVID-19 related disruptions to activity and corporate earnings this year and focus on the future. Second, as interest rates are a key input into the rate used to discount a company's expected future stream of earnings or cash flow to the present value, these lower interest rates have meaningfully boosted stock valuations. And finally, with central bank policy rates, bond yields and term deposit rates all now at depressed levels, income from traditional fixed interest sources has disappeared, which has forced investors into other asset classes in the hunt for a return, with equities a clear beneficiary. We suspect all these forces have further to play out.

Our medium-term optimism towards equity markets is reflected in the overall positioning of the MAS Funds, where we maintain their exposure to growth assets (equities) at their strategic asset allocation targets. In fact, we are actively assessing tactical opportunities to increase their growth asset exposure where it would be appropriate. In addition to this, we continue to search for opportunities within the Funds to further position the portfolios for not only cyclical investment opportunities (as economic activity recovers from the pandemic) but also some of the secular trends that we feel are likely to dominate in a post-COVID world. Some of these trends are new, while others have been around for some time but have been accelerated by the pandemic.

In the near-term, however, we feel there are two clear events that could lead to some financial market volatility over the next few months. These are the US election and a potential COVID-19 vaccine. New Zealand, of course, has an election too, but we see this having very limited impact on markets overall, in large part because they have likely priced in the outcome suggested by current polling already.

- **US election.** In true 2020 fashion, the election campaign has already been action-packed, with the death of a Supreme Court judge and a controversial nomination process underway, refusals to commit to peaceful transitions of power, an almost unbelievable first presidential debate, plenty of discussion around the validity of mail-in ballots, and President Trump being diagnosed with COVID-19. This is all at a time when President Trump and former Vice President Biden are the two oldest candidates in US political history, and polarisation and partisanship in the US is already at extreme levels. Polling, betting markets and some high-profile election models have all pointed to increased odds of a Biden victory recently, and with it the likelihood of the Democrat party also taking control of the US Senate, which if this did transpire would allow a far easier path for it to push through its policy agenda. While this would include market-negative policies like higher corporate taxes and potentially increased regulation, investors appear to be taking comfort from the fact that higher levels of fiscal stimulus are almost certain under a Democrat victory and the odds of a contested election (and potentially lengthy delay before the result is known) have arguably fallen. Of course, the 2016 election surprise is still fresh in many investors' minds and there is certainly still the potential for more twists and turns yet, particularly as the result is ultimately determined by a handful of swing states.

US Electoral College Map: Watch the Swing States



Source: RealClearPolitics

- **COVID-19 vaccine.** While it is impossible to measure accurately, we feel that markets are already factoring in a reasonable chance of the successful development of a COVID-19 vaccine. With the Milken Institute reporting that nine vaccine candidates are now in stage three clinical trials and with the companies involved providing reasonably encouraging updates so far, this seems like a logical conclusion. It appears as though we will have some results before the end of the year, and if so, we feel this would provide a further leg of support for markets – especially more cyclical parts of the equity market – as investors can more confidently start to price a faster resumption of economic activities damaged by mobility restrictions. Of course, the converse to this is that if there is any slippage in the vaccine development timeline or if trials prove unsuccessful, this would likely be a meaningful setback to financial markets.

The ultimate question for investors though, even with these critical 'known unknowns', is do they change the bigger picture? Our answer to that is probably not. Depending on how various scenarios play out, they certainly may alter what sectors of an equity market you'd prefer to own and those you would prefer to avoid, but we don't believe they change the broader macro backdrop and supportive policy settings (discussed above) that are likely to stay beneficial for equity markets for some time yet. In that regard, we would view any market volatility that arises over the next month or so from the US election and vaccine trials, or likely any other factors for that matter, as potentially an opportunity to add to growth asset exposure within the MAS Funds if that was deemed appropriate.

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