

Squaring the Political Circle

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With all eyes focussed on the US election this week it is vital for investors to understand the implications, short, medium, and long term, of the results of the Presidential race. No formal winner has yet been announced but whichever candidate wins, it will be by slim margins in several key states. This will not be the landslide the polls predicted, and this has major implications during the current economic downturn.

Investors have to think through the implications of the US election, but we believe the market reaction is rational. Pollsters have been talking up the 'Blue Wall' trade, where cyclical companies perform well based on a reflationary fiscal spend from a Biden administration. That has now dissipated with the realisation of a close outcome, and the likely prospect of a Republican Senate, which will frustrate any ambitious plans of a Democratic president. A move back to less cyclically exposed technology and growth stocks is rational in this light.

In reality, the pandemic has turned from a short sharp financial shock to a more sustained period of economic weakness which, historically, takes a couple of years to work through. The last real prolonged economic downturn the world experienced was between 2000 and 2003.

In this environment, central banks will have no choice but to leave interest rates near or at zero for a prolonged period. Governments should spend on investment projects to help stimulate activity and build for the recovery phase, but they are hampered by divided electorates in most major economies. The US result is no different to that in many other countries where no clear political consensus is apparent, other than that fact that there is no consensus. This puts a brake on the latter of these two economic levers.

Countries that managed the 2008 crisis well, namely the US, flourished in the decade after at the expense of others. This time, Asian countries (including Japan) and the US (for structural reasons) are likely to be the net beneficiaries in a difficult global economic environment. As economic growth remains below trend, countries and companies will need to take market share from rivals to grow and this will lead to trade tensions remaining high, with a consequent turning-in at the regional level.

The next twelve months will likely see a swathe of corporate collapses and merger activity where weaker companies are taken over by stronger competitors that have managed their businesses conservatively to date. This should, theoretically, lead to a reduction in capacity globally and to a rebalancing of the supply/demand dynamic that has driven down inflation over the past 20 years. This is healthy in our view and a positive factor for investment in the medium term.

Inflation is a possible issue in isolated regions but will only occur if a currency is materially weaker than its other trading partners. If all devalue, then technically, there is no inflationary impact.

The digitisation of the world will continue but the impact on earnings for the largest companies will decline as their costs rise, competition increases and they suffer diseconomies of scale. Interestingly, this was seen in Amazon's results last week as the cloud computing business, AWS, grew but also had its margins clipped.

With all of this in mind, the equity component of our strategies is skewed heavily towards exposure that has high return on cashflows, strong franchises globally, low corporate debt levels, less economic cyclicalities and a focus on accretive acquisitions to enhance bottom-line profitability. All strategies are underweight in equity exposure at the headline level at

present, but this is wholly down to the lack of cyclical exposure rather than a negative view looking out 12-24 months.

An economic downturn is a clearing mechanism in investment markets and investors should embrace this rather than run from it. How and when prices react to a more positive outlook cannot be forecast, as this week has reminded us all once again.

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