Investor Insight

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General economic overview – Quarter 4 2020

Like much of 2020, the fourth quarter had several twists and turns that resulted in economic and market uncertainty.

After a tumultuous and volatile year, the dangers of longer-term predictions could never be better illustrated. After a huge hit to economic activity in the first half of the year economies, aided by huge monetary (central bank) and even more importantly government fiscal support, have started the long road to recovery. With a huge abundance of global liquidity stock markets, together with corporate credit, have front run the anticipated upturn in economic activity with markets bottoming-out at the end March/early April. Stock markets have always looked forward and in the period since the Financial Crisis, have done so at a faster rate than previously. Investors are now looking to the end of 2021 and beyond to try and see how far the global economy will be below what it would have been pre-Covid and more importantly whether the economic cycle can resume.

It is somewhat ironic that during the second half of 2019 one of the largest concerns in the market was whether the weak manufacturing sectors in the developed world would impact these now service orientated economies. Covid-19 has hit the service sector harder than manufacturing. Companies operating in the service sector which relied on a high level of personal service and human interaction have, unsurprisingly, been hit hardest and as a result have seen significant falls in their share prices, often combined with the necessity for re-financing corporate balance sheets. This has been demonstrated once again in the northern hemisphere, and in Europe and the United States there has been a significant pickup in new infections as temperatures have fallen and schools returned. During the summer months consensus economic forecasts had generally been revised upwards, together with earnings estimates compared to the forecast outlook in April, but in the light of further lockdowns and restrictions in the third and now fourth quarters the V-shaped recovery has certainly flattened off raising doubts as to whether there can be a full rebound in economic activity in 2021. The latest mutations in the virus illustrate how we are far from being clear of the problems set by the pandemic, despite the consistently good news on vaccines.

Vaccines have dominated the news since November with stock markets reacting positively to the news whilst the realities and practicalities of the roll-out will mean much of the first half of the new year will be focused on this and further demands on the health services around the world. Another less referenced subject is that of treatments for coronavirus which have also improved, and President Trump demonstrated this after recovering, having received Regeneron's highly expensive monoclonal antibody treatment.

These improved treatments explain the lower mortality rates, even in countries now enduring a second wave.

The world is clearly highly dependent on vaccines to see a return not only to more normal levels of economic activity, but also to previous ways of life and it is a vaccine which will end social distancing and restrictions on travel. However, even with a successful vaccine there are several structural changes in the economy which have been accelerated by the pandemic and which will result in permanent change. There has been a massive structural shift in the economy and arguably the largest channel shift in the history of the internet. Many technology-enabled disruptive businesses able to offer products or services online have seen at least four years expected growth occur within six months. Arguably some investors are still underestimating the impact of this. Within the retail sector many legacy businesses have not had the working capital to re-stock before Christmas, and as a result there have been further failures in the high street. Further lockdown measures that were announced for the Christmas period and now beyond will only further benefit these online businesses.

Even in a Covid-19 free world, the acceleration of already occurring structural change will result in a global economy very different from what was expected 12-months ago.

The support of governments and central banks has been crucial in maintaining confidence in the future and that a post pandemic society, with the aid of vaccines, can move forward on a positive economic trajectory. This kind of stimulus does have consequences which will need careful consideration by investors. There is now a huge amount of government debt, looking at debt to GDP ratios, and globally there is now approximately 16% more debt than at the start of 2020. Whilst debt levels were high coming out of World War II, back then there was a huge amount of catchup necessary on infrastructure spending but demographics, through the baby boomers, were positive.

Potential growth rates today are much lower than before unless productivity grows significantly. This suggests that over the medium term a low growth and low inflation scenario will continue. The global economy is likely to remain in a demand deficient world where there is a continued high level of excess savings. One difference between now and the post GFC recovery is that whilst both periods saw low interest rates, a belief a decade ago in fiscal orthodoxy meant most governments put in place austerity measures to reduce debt. With high levels of unemployment once more and the growth of populism, these past policies are unlikely to be repeated. At present it is too early to say whether the massive amount of stimulus for global economies that will be present in the first half of 2021 will result in a cyclical uptick in inflation, although structural disinflationary forces will remain as a longer-term influence.

The outlook for 2021 is certainly more optimistic than could have been anticipated in March and April 2020 with the pandemic uncertainty at its height but we are clearly dependent on a successful roll out of the vaccines to maintain growth prospects.

Equity markets

Given the optimism we saw at the start of the year and the effects of the pandemic thereafter we have seen quite a roller-coaster of market movements in 2020. It is not unexpected that such a violent economic shutdown would cause a steep decline in company valuations. What has been more surprising has been the resilience of some sectors and markets and the speed of recovery in valuations.

Overall European markets, including the UK, have underperformed the US and Asian markets this year. Central bank support has been a key element in keeping businesses and economies afloat in the crisis and this has backstopped markets from a freefall in the early stages of the pandemic. Since then, we have seen some sharp recoveries in certain sectors that have benefitted from the current economic conditions. The most obvious has been the technology sectors, led in the US by the FANG stocks. There has been commentary about the narrow market this year with a small group of significant winners and in fact this has been the perspective of many value investors over the past five years. Academic research has shown that long-term equity returns are dominated by a relatively small number of stocks. A study of US equity returns by Hendrik Bessembinder, an academic at the University of Arizona, looked at data over 90 years and found that nearly all of the gains were delivered by only around 4% of the stocks. Over the past decade the world has become more interconnected than ever, with the internet, mobile and social networks. Markets that were once independent have become interconnected resulting in companies benefitting from network effects and/or social effects, both of which create bigger winners. This is a structural change accelerated by the pandemic.

November saw a rotation away from some of the previous winners of the earlier pandemic world whilst innovative healthcare or biotech stocks have continued to perform strongly. There is now a belief that the post Covid-19 era will see several transformative healthcare treatments become commercialised. The gap between so named value stocks and growth stocks widened significantly during the pandemic but the recent vaccine news did remind investors that those downtrodden stocks can have significant value if we move back into a more normal economic environment. The high street and the travel industry were some of the worst hit areas and it remains uncertain as to what sort of recovery can take place in 2021 if we remain in a restricted global environment.

There are some consistencies that continue to create optimism in investors. The Fed continues to be willing to take unlimited action to prevent further market illiquidity and disruption, which means the equity risk premium should be much less volatile going forward, even if further waves of the virus continue to threaten the recovery. The US have recently signed off their $900 bn Covid-19 aid bill averting a government shutdown with the travel industry being a strong beneficiary.

Quarter four saw equity markets rise once again after a weaker third quarter. Over the year the strongest returns were global with the US, Japan, and emerging markets the strongest sources of return. Both the UK and Europe saw negative returns with the UK main market down 11.4% and Europe ex UK down 2.6% (source T.Rowe Price).

UK

There has been a mixture of positives and negatives for the UK as we move into 2021. The vaccine news has been very positive and reflected in markets, and the recent Brexit deal was positive for the economy and the pound as it passed through parliament. All this however has been put on hold for the time being because of the further rise of Covid-19 cases and the subsequent stress on the NHS and the December lockdowns (and, as we write, January lockdowns) recently employed. Although Q4 data is not yet available there is a likelihood that the economy could fall into a double dip recession.

Figures for July and September looked encouraging with the economy shrinking less than expected (8.6% smaller than the end of 2019 with earlier estimates at 9.7% - source ONS). The outlook has deteriorated since then however with estimates now at a 2% drop in GDP in the fourth quarter. This drop-off should however be a lot shallower than the first as vaccinations begin to quell the spread of the pandemic and a sharper rise in household spending could result. ONS data indicates that household saving has been around 16.9% in 2020, more than double the long-term trend of 8%, leading some economists to forecast a strong recovery in the second half of 2021 if vaccines are effective. Longer term effects of the pandemic are highlighted in public sector borrowing numbers which were at highs in the first eight months of 2020 with a record £284.7bn borrowed to cover the gap between revenues and spending.

With the hurdle of a Brexit trade deal overcome and the vaccine distribution coming into full swing in the first half of 2021 the outlook for the economy is more positive. At the moment it is unlikely to bring with it inflation, but this is an outside risk later in 2021 if we see a significant surge in household spending.

US

The final quarter of the year was, as expected, dominated by two factors – the pandemic and the US election. The former saw grim US data as the case count continued to rise with the President confidently ignoring the advice from experts and concentrating on re-election. The pandemic still rages in the US, but the vaccine announcements seem to have retained market positivity despite the rising case count.

One of the more consistent effects of the pandemic in the US has been the theme of the strong getting stronger. The names are not surprising – Amazon, Nike, Starbucks, McDonalds and Mondelez to name but a few have all boasted resilient profits in 2020. This fits the K shaped recovery we discussed in our Q3 review illustrating a very unequal rebound which is dividing the US economy. The gulf is growing between the largest and best financed companies and those lacking scale. Central bank policies coupled with shifts in consumer behaviour have accentuated trends that have been putting more wealth and growth into the hands of a few large companies.

The winners have tended to have a global footprint, and many have been in the technology and pharmaceutical sectors, able to ride out the pandemic waves more easily. The main factor underlying this for all successful companies has been investment in digital tools which have been critical as employees and consumers have scattered. Consumers have reverted to brands they trust, and smaller companies have struggled to compete, not least because they have had less access to capital. Very few industries have added jobs this year, mainly ecommerce, tech groups, banks and insurers as well as large operators such as Costco, HomeDepot and Walmart.

These organisations have investment grade ratings and can borrow at substantially lower rates and have done so significantly in 2020 with $2.5tn of corporate borrowing this year. The pandemic has also highlighted those companies with weak balance sheets and those in sectors that have struggled such as retail and hospitality.

One of the effects of US central bank policy has been for the dollar to remain weak against a basket of foreign currencies. This has been most obvious against the euro which is up 10% against the dollar in 2020. The main reason for this has been the view that the Federal Reserve is unlikely to raise rates anytime soon to protect US companies and encourage growth and lending.

The main change for the US in the coming months will be that of the administration which will see Joe Biden replacing President Trump. At the moment this suggests a more balanced leader at the helm with an opportunity to reset some of the stranger policies of the Trump era such as leaving the Paris Climate Accord and re-joining the WHO.

Other areas may look familiar in terms of disputed trade policies with China although the rhetoric will probably be less aggressive.

Europe

Europe has, like the UK, had several other issues to contend with outside of Covid-19 this year although the core economies have generally managed to maintain reasonable controls over the spread of the virus in the first wave with perhaps the exception of Italy. A number of countries in Europe have been slower than the UK in approving the vaccines, and Germany and France are behind the UK in terms of their immunisation plans with the French population remaining more sceptical than other European countries.

When the data is finally reviewed there is no doubt that Covid-19 will have a significantly negative effect on the Eurozone over 2020. Rising unemployment and income losses will hit consumer spending, investment will suffer amid elevated uncertainty, and collapsed foreign demand will hit exports. The economy is seen as contracting around 7-8% in 2020 with GDP growing to around 5% in 2021.

There has been some good news in countries which were badly affected by the pandemic as manufacturing activity in Spain and Italy showed growth in the last quarter of 2020. Italy recorded its seventh consecutive month of expansion in December according to the IHS Markit PM Index. Spain's PMI rose above 50 in November as well.

The source of growth was in Asia where demand reflected the uptick in economic activity. Overall, this reflects well on the Eurozone's ability to weather the latest wave of the pandemic. Confidence for 2021 amongst eurozone manufactures has risen strongly in Q4 and many are recruiting. It is not the same in the service sector, where many jobs have been lost and survival still hangs in the balance for many companies in areas such as travel and retail. The ECB is still supporting the European bond market although it is not as expansionary as the US or Japanese central banks.

Europe has recently entered into a controversial investment agreement with China, much to the annoyance of the incoming US administration. The US wanted a more multilateral approach to China to make it re-consider its trade and human rights position and this has weakened the European relationship with the US. The agreement was pushed through by the German Chancellor putting trade and the auto industry ahead of other factors.

Elsewhere, the Brexit deal has been viewed with a sense of relief by many manufacturers although the financial services sector has not seen as much clarity from a UK perspective. Trade will at least enter 2021 tariff-free which is the first step to a stronger ongoing relationship with the UK.

As we conclude this review virus cases are on the rise in Europe, as in the UK, and more restrictive measures are being put in place which will slow down the pace of recovery.

Asia & Emerging Markets

The focus of the region is always on China, and this has been positive for much of 2020. China has been more effective at reducing the spread of the virus which has been reflected in asset prices. Industrial production in China has powered to its highest rate of growth in 2020 surpassing most of 2019, consumption has recovered, and exports are booming, rising by 21% in November. Not all data is positive as the consumer price index fell into negative territory for the first time in a decade. The headline rate of minus 0.5% was mainly related to pork prices which is a significant component of the basket used to calculate prices. It reflected the drop from the previous hike in prices caused by the outbreak of African Swine fever in 2019. Even if food and energy are removed, the core inflation figure has remained stubbornly low for the past six months, at 0.5% which is puzzling given China has had the world's most resilient rebound from the pandemic.

This suggests that households have a limited appetite to spend and raises problems for the future as it could eventually slow the pace of recovery. It is also partly to do with the Chinese government concentrating on supply side measures to boost the economy during the pandemic, alongside virus prevention, rather than the consumer. They succeeded in a rapid recovery of industrial production, creating supply but not demand. There is some light at the end of the tunnel however, as factory gate prices have started to rise in November, thanks to export growth, as western governments have encouraged household consumption. There are other more positive signs as well with an improving job market and falling unemployment rate, although official figures do not take account of migrant workers that have been hit hard by the pandemic travel restrictions.

Other areas of conflict in China include the central governments battle with the Jack Ma's ANT Group, the eventual aim of which is to move the company's financial technology group into a financial holding company. This will bring it under the control of the Peoples Bank of China a critic of the group's more flexible approach – the IPO was cancelled in November.

Elsewhere, the EU-China investment treaty, seven years in the making, has come under US scrutiny as they want the EU to join a multilateral approach to put pressure on China over human rights and trade.

India is the second largest of the Asian economies and has struggled to deal with the pandemic as effectively as other more controlled economies. Economic activity has still been improving with quarter 4 PMI data showing expansion for the first time since March. Household spending remains subdued as targeted containment measures continue. To combat this, there has been further stimulus measures with spending aimed at infrastructure projects, job creation and credit growth. The Indian government are preparing for a mass vaccination program now the Astra Zeneca vaccine is available.

In economies such as Argentina and Brazil the situation is much more unstable as increased consumer pessimism has taken hold, which suggests the recovery seen in Q3 is losing momentum. Many of the Latin American countries have faced the same problems with a less effective health service added to high unemployment and rising public debt leaving a number of downside risks still apparent. One positive for many economies that rely on the dollar is its current weakness. This, alongside low rates which are predicted to continue for some time, is a benefit to those dollar borrowing economies. In all these countries, a lack of fiscal headroom has meant implementing support measures for consumers has not been possible and as a result recessionary conditions are likely to prevail significantly longer than in Asia.

Within the emerging world Asia, and especially North Asia, is best placed for an economic rebound, and will remain fast-growing compared to both the emerging and developed world. Within Asia cultural factors mean that individuals have a strong desire to make more of themselves and there is still a generation of people who have moved from poverty to being better off and want to progress further.

This will continue to be a driver of Asian economies. With supportive valuations and the likelihood of further significant US dollar strength diminished, Asia looks well placed to outperform in 2021.

Japan

Japan continues to have significant structural issues, the most significant being a declining population, but with a high debt to GDP ratio and national debt at over 200% of GDP there are other headwinds to stimulating the economy. The Japanese stock market has however had a good year with the Topix up 6.7% (local currency) but it is still 41% down on 1989 highs. The problems of a deflationary environment have been well documented but not all is negative for investors as the Asian region is stronger and has weathered the pandemic much better than other global economies. Technology, in which Japan has invested heavily to overcome some of these structural problems, has been at the forefront of the positivity in stock markets around the globe and looks likely to lead the way again in 2021.

Government data released last week showed that Japan's industrial output growth was flat in November, well below economists' 1.2% growth forecast. This reflects the weakness of the global economic recovery and a resurgence in the global number of new infections, which has crimped demand. Given the weak economic conditions, Prime Minister Yoshihide Suga's government and the ruling Liberal Democratic Party (LDP) concurred on the need for further aggressive stimulus measures. At December's meeting of the General Council, which is the ruling party's highest decision-making body, even the most hawkish fiscal conservatives voiced only modest concerns about the record JPY 106 trillion (USD 1 trillion) proposed budget for 2021.

Politically, Japan has been stable following the retirement of Shinzo Abe although Prime Minister Suga has had to face problems in healthcare in the pandemic as well as some smaller scandals which have seen his popularity fall. Pandemic rates of infection have been rising and may yet cause a tighter set of restrictions in Japan in the early part of 2021.

Fixed interest

The various options in the bond market currently seem relatively stable with central banks supporting the status quo by purchasing huge chunks of the market to support debt issuance from governments and corporate stability. This raises an interesting question for investors which is how this increasing debt pile will be financed and what will happen when central banks start to back off from their debt buying?

The clearing price is being artificially set by government agencies like the Bank of England and the Fed, with the BoE holding close to 50% of the country's stock of debt. At some point debt must be repaid and assuming there is a longer term sustainable economic recovery, governments will need some inflation and potentially higher taxes to address this, but markets are not judging this to be an issue for the immediate future.

As always, the returns investors can expect will depend on the risk they are prepared to take. At the beginning of the pandemic there were some clear opportunities in spreads as they widened significantly but this ship has sailed for most investors. Spreads are now running much tighter and although there may be some potential moves, as news on the pandemic varies, they are much more marginal in terms of delivering gains. There will be more options in the high yield market and in emerging market debt, but risk is a clear factor with currency also playing a major role. In 2020, investment grade bonds offered the strongest return ahead of government and global bonds, but this is unlikely to be reflected going forward. Several managers offering strategic products still view spread management as a potentially good source of return in 2021.

The other consideration for investors looking to manage risk in their portfolios is the potential for yields to rise and inflation to hit bond prices. A survey of investment managers by the Bank of America in late 2020 suggested a high proportion of them, 76%, expected a steeper yield curve in 2021 with longer rates rising above shorter term rates, the curve is currently relatively flat. Higher yields mean lower prices, but the system is complicated by central banks and governments. Generally, governments want yields to remain low for the time being, to help recovery, but there will be a time when tapering will occur and potentially when inflation returns. To a certain extent the US treasury market has already seen a steepening of yields which is priced in for the time being and if the rest of the world is still not seeing inflation and supporting low yields the US cannot move ahead on its own. At the same time the US wants to fund vast spending programmes and to do this they may need to issue longer term debt at attractive prices – which may move yields upwards – but even this is unlikely to force yields up dramatically, with economists suggesting a rise from just below 1% to 1.5% for the 10-year US Treasury note.

Any imbalance in the supply and demand for these assets is likely to see central bank intervention which should keep yields relatively stable during 2021. Potentially higher rates bring in other risks as well and although default rates seem to be relatively low, given the state of the economy, and rates for financing debt are also low, the fear of zombie companies operating is a threat to future default levels, should rates head upwards again.

An end to the bull run in bonds has been called a number of times in the last few years but this may be the turning point for yields being able to fall further, particularly if we do get a robust recovery later in 2021 as the coronavirus threat reduces.

As we noted in the Q3 review the case for holding government debt is less convincing at this point although general economic uncertainty means it is still worth a place in portfolios as a safety valve. Investment grade is more attractive although with tight spreads in place the opportunities remain limited. High yield and emerging market debt hold greater opportunity but will be more volatile.

Property

Earlier in the year we saw the suspension of all physical property funds as the FCA's material uncertainty clause came into operation.

This was intended to be a short-term tool and we saw the clause removed in Q3 from almost all property assets, allowing property funds to open, or at least plan their re-opening. Since the previous quarters review, we have seen a number of funds re-open, although not all, with significant outflows initially and then a gradual slowing down during quarter four.

There have been some structural changes in the economic environment, and these have been reflected in the property sector.

Retail provides the clearest indication of this trend and continues to underperform, particularly shopping centres and high street shops, with supermarkets and retail warehouses showing greater resilience during this pandemic. While investor demand for the overall retail property sector will struggle to pick up in the near term, investors are likely to remain focused on core, well-located retail space with secure and long-term income streams, underpinned by high-quality tenants. The office occupational market remains subdued, with limited leasing activity reflecting delayed occupier decision-making. This is partly indicating the normal reaction of companies to economic weakness, but also the pandemic's impact on working from home.

Anecdotal evidence suggests retail footfall was down significantly during lockdown, however within the sector the impact has not been evenly distributed. Retailers selling goods deemed essential have remained open for business, including supermarkets and pharmacies.

Consumers did return to the high street in the summer months but not in the same numbers as pre Covid-19. It seems unlikely consumers will return to the high street in sufficient numbers to prevent more businesses following the likes of Laura Ashley, Clintons and Top Shop into administration. This environment highlights the value of stock picking investments based on tenant-by-tenant due diligence, which ensures assets generate sufficient revenues for

Summary

occupiers to allow them to trade profitably and continue to pay rent. Rents have clearly been affected and a similar pattern has emerged with retail and leisure sectors the worst affected and industrials, warehousing and offices still being relatively robust. With changing lockdown rules (at the time of writing we are entering another full lockdown in the UK) restrictions limit the ability of properties to move back to full prelockdown usage. Property fund managers have been managing their portfolios through this period with many increasing cash levels by selling assets, although activity has been lower in Q4. At this point not all managers are in the position of having high enough cash reserves to deal with the potential level of redemptions. The likelihood is that we will see negative capital returns from several commercial property sectors when we fully analyse 2020, but with certain sectors like warehousing and industrial sectors continuing to thrive.

The global REIT / property securities market is sensitive to interest rate movements with the global REIT space dominated by US assets, therefore the path and outlook for US interest rates and US economic growth will be important influences on future returns. These assets offer investors a way into holding commercial property, but they are much more closely correlated to equity market volatility and may increase portfolio risk.

The position for many investors in direct property is probably now as much about liquidity, access, and timeframe requirements as it is about the diversification that direct property can provide. With FCA changes soon to be published this may become more difficult to manage for those with a shorter-term investment horizon as access to funds could be more restrictive. Fundamentally, direct property can offer low correlations to other asset classes so should not be ignored but clearly practicalities need to be factored into any investment decision.

It seems likely that 2021 will see successful vaccines allowing the world to return to some kind of normalisation, but the ‘new normal’ will be different to the pre-pandemic world. There are several structural changes in the economy which have been accelerated and will result in permanent change. One of the main differences will be the higher prevalence of working from home, and this is likely to impact on demand for office space going forward. Whilst some businesses have done well, there will be bankruptcies and job losses and whilst capitalism has thrived long-term on the process of creative destruction, in the short-term there can be an economic hit with lower levels of output and higher unemployment. Technological benefits, together with demographics such as ageing populations and globalisation means inflationary pressures will not pick up dramatically over the medium term. Technological pressures may also help keep wages low with working from home a lower cost option for many employees.

The ability of stock markets to look through shorter term problems has been demonstrated by the reaction of markets to the November/ December vaccine news. Markets have rallied strongly despite the emergence of a second coronavirus wave in most northern hemisphere countries. There is now a belief that economic scarring will be lower than from the Financial Crisis if vaccine news remains positive. Geopolitical concerns for stock markets have also receded, but these could re-surface on investor’s horizons post the inauguration of Biden in the States where different policy stances on either China or Russia could emerge. The election of Biden as US President without a so called ‘Blue Wave’ has led investors to believe that the current goldilocks scenario of moderate economic growth but continued easy monitory policy can continue for a number of years.

The greatest potential for an upset to equity markets would be a sustained rise in bond yields if investors believed current loose central bank monetary policy would result in markedly higher levels of inflation that would lead to significant monetary tightening down the road. Whilst forward inflation expectations looking at the five year/five year rate in the States have risen, they remain below the Fed's long-term inflation target of 2%. Whilst a modest steepening of yield curves is likely, with continued Central Bank QE policies around the world suppressing the level of government bond yields, this does not seem likely to be a problem in the first half of 2021 at least.

Investor complacency is always a danger and perhaps the most worrying aspect for markets is that there are now much higher levels of optimism than six months ago. Short term valuations remain elevated, although an economic rebound will see multiples fall quickly if the expected earnings improvement comes through. Over the course of 2020 many companies have reduced their cost base, so the recovery in corporate earnings, combined with the inherent operational gearing of most businesses, means earnings can recover much more rapidly to previous peak levels than GDP. Overall, with further positive vaccine announcements likely, and a normalisation of economic activity, combined with the extremely low level of bond yields and cash interest rates, investors should remain exposed to equity markets whilst keeping an eye on shorter term cyclical inflationary pressures which could induce periods of volatility. The recent increase in lockdown restrictions illustrates the short-term dangers of the current environment and any delays to the rollout of the vaccine will increase anxiety in markets although this is not likely to be long lasting.

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