Market Commentary

April 2020

Overview

In the six-and-a-half years that I have been writing these commentaries, I have rarely broken the fourth wall, so to speak. However, given the unusual circumstances in which we find ourselves, it seems right to do so again. Having worked in the City for almost thirty-six years, I have experienced the crash of 1987, the Asian crisis and demise of LTCM, the Tech Bust, 9/11, the Great Financial Crisis and Eurozone Crisis, and yet none of these compares with the COVID-19 pandemic. The novel coronavirus that causes the illness poses an existential threat not experienced, outside periods of war, for more than a century. It is almost inevitable, statistically, that many readers of this report will develop symptoms of varying levels of severity, and also that some will experience loss of life amongst those near and dear to them. Even so, our clients' financial health remains a priority for us, and, as usual, I will lay out the main factors that have driven market performance as well as our view of the future – for however much we are currently bombarded with depressing news, we are confident that this is a temporary cycle rather than a permanent state.

The story of the first quarter of 2020 had its beginnings in December 2019 in a wet market in the city of Wuhan in the Chinese province of Hubei. It was here that a novel coronavirus made the jump to a human from an as yet undetermined animal host (although there are several suspects, including bats). There were, prior to this episode, two hundred and fifty-six viruses known to affect humans, with most of them contained either by herd immunity or vaccination. The reason that this new virus, SARS CoV-2, was so dangerous was that nobody was immune to it, especially as it turned out to have a high infection rate, leading to exponential growth in the number of cases if not contained.

The outbreak in China was initially seen largely as a threat to global supply chains, which would have been disruptive but only to a limited degree. Even as the virus spread through other parts of Asia there was no sign of panic. Indeed, and almost unbelievably in retrospect, many major equity indices made new all-time highs in mid-February. However, as the virus spread through Europe and then on to North America it became clear that the outlook was much more negative. The high infection rate of the virus meant that healthcare facilities were going to be overwhelmed if nothing was done to check its spread. This led to the current situation of social distancing and self-isolation, which is creating a demand shock of hitherto unseen proportions. Even during the financial crisis one could drown one's sorrows with a trip to the pub or a restaurant, but even those simple pleasures have been withdrawn, along with all public gatherings.

The net effect of all these constraints will be a global recession of epic proportions, with the attendant risk to corporate profits, balance sheets, and, crucially, dividend payments. Of course, the pain will not be felt equally. At one end of the scale two million flights had been cancelled globally by the end of March, with both airlines and airport operators seeking financial support. At the other end, grocery sales in the UK jumped a record 21% in March as everyone filled their cupboards with provisions. Companies offering online entertainment and connectivity have seen booming demand. Even in tough times there are always relative winners. In aggregate, estimates now suggest falls of 30-50% in earnings per share for 2020 as a whole, although pinning down an exact number is well-nigh impossible, especially when companies themselves are withdrawing profits guidance owing to the uncertainty. There could conceivably be no earnings whatsoever in the second quarter for the market as a whole.

Economists are still hurdling over each other in a "race to the bottom" to pin down GDP growth (or more accurately decline) forecasts. There seems little doubt that the second quarter will define the trough of activity, given that virus containment measures do appear to be reducing the incidence of new cases. We could see falls in activity of well over 10% in many countries. Global GDP forecasts for the year are currently homing in on the level of minus 2%, although this is by no means a floor.

Much uncertainty remains about the slope of the recovery. Initial thoughts rallied around a 'V'-shaped recession, but now a 'U' is gaining ground, or possibly a more drawn out recovery. Much will depend on how well contained the virus remains once social distancing policies are relaxed. If serological antibody testing is introduced quickly and widely, people who have been exposed to the virus and acquired immunity (while possibly experiencing minimal symptoms) might be allowed to resume normal activities. A vaccine would be the "silver bullet" solution, although most experts believe this to be as long as twelve months away. Even so, with the world's pharmaceutical resources assembled to focus on a single target, there are grounds for optimism, and regulators will fast track potential winners.

Taking a more positive tack, we have been impressed by the response of both central banks and governments. One key lesson learned from the financial crisis was that the banking system must be kept functioning, and this appears to have been guaranteed by central banks promising to extend unlimited liquidity. Therefore we do not expect to see a repeat of the financial crisis. This is important, because banks are intended to be the main conduit of financial assistance to the private sector through the provision of government-guaranteed loans (yes, this time round they are the good guys!). These are designed to tide companies over a period when income will be severely constrained. Governments around the world have so far announced fiscal measures amounting to more than 5% of global GDP. The United States' package ran to more than $2 trillion, or around 10% of GDP, and President Trump is already agitating for a further $2 trillion infrastructure spending programme. There is more to come on this front.

Of course, all this fiscal support means a potential explosion of government debt. In the past this might have been seen as cause for further alarm, but now seems a lot more like what many had been clamouring for anyway, perhaps under the label of "Modern Monetary Theory", itself a way of describing debt monetisation, whereby government bonds are largely bought by central banks. Japan has effectively been doing this for years. The Bank of Japan has also been implementing what it calls "Yield Curve Control", meaning that it acts in the market to suppress government bond yields. Even if there is not yet an official policy elsewhere, there is much talk of such measures being introduced more widely. There are questions being asked as to whether all this monetary and fiscal stimulus will finally release the inflation genie from the bottle in which it has been trapped for years. Given the countervailing disinflationary forces of technology and demographics (and the unknown after-effects of COVID-19), this remains a thorny issue. However, given that higher inflation is seen by many as the only antidote to the historically high debt burden, portfolios will need to carry some insurance against that risk. Gold has benefitted from such a prospect.

Finally in this section, some comment needs to be made about the violence of equity market declines in March. The S&P 500 index, for example, entered bear market territory (-20%) just 19 trading days after hitting an all-time high, a record of dubious distinction. The Crash of 1929 took a snail-like forty-five days to cover the same ground. The latter part of the recent decline, which took global equities some 35% from their peak, was exacerbated by what one might describe as a "liquidity event", during which even safe haven assets, including gold and sovereign bonds, were sold almost indiscriminately. Some of this was investors selling whatever they could to raise cash in thin markets, some was selling forced upon investors by fund redemptions, but a large element, running into hundreds of billions of dollars, was sales by funds who scale the size of their investments through leverage according to the level of market volatility. As volatility rose, they had no option but to reduce the gross size of their funds. As best as we can ascertain, much of this phenomenon is now behind us, leaving investors to focus more on three prime fundamental factors in determining their actions: the evolution of COVID-19 cases and associated deaths; the influence of the response to the virus on economic growth; and the effect of these on corporate profitability.

Markets – UK

One element of support for the UK equity market in recent years has been its dividend yield, the highest amongst major markets. This support is now being eroded quickly as companies are forced to conserve cash, at least on a temporary basis. At the time of writing, all the UK's major banks have just announced the suspension of dividend payments, including those already declared for the second half of 2019 – this under some coercion by industry regulators. Banks account for about £16bn of the annual market pay-out of just over £100bn. Oil majors, another large source of dividends, are doing all they can to maintain payments, but an oil price of not much more than $20 per barrel will not make that easy. In aggregate we expect to see a reduction in dividend payments of 40% or more this year, although we emphasise that they will recover swiftly, even if not immediately to previous levels. A historical yield of 6% is now below 4% prospectively.

US

The US is now the epicentre of the coronavirus pandemic, but the upper echelons of its stock market remain packed with companies that provide the sort of services that we utilise when in lockdown. However, there is likely to be backlash against historically high levels of share buybacks, a phenomenon that, apart from boosting earnings growth, has led to many companies carrying debt levels that suddenly appear unsustainable. Top of the list of miscreants is the Airline sector. Any bailouts for that industry will come at the price of meaningful government ownership and reduced future cash distributions. In more normal times we would pay greater attention to the race for the White House in November, which now looks as though it will be a Biden vs Trump competition. It seems to be a very close call, and a subject to return to when the COVID-19 dust settles.

Europe

Europe is one of the regions worst hit by the coronavirus, and this comes hard on the heels of last year's US/China trade war disruption, meaning that Europe was hardly starting from a strong base of growth. The European Central Bank has, at least, promised to provide the necessary liquidity support (after some initial missteps), but government-led fiscal response remains piecemeal and nationally focused. Calls for region-wide stimulus continue to fall on deaf ears in the core northern countries, reigniting fears of a two-speed euro zone. Dividend futures in Europe (which admittedly have turned out to be too pessimistic in past crises) point to a 60% reduction over 2020/21. France's decree that any companies taking state aid in any form will have to suspend dividends and buybacks will in all probability become the template for all countries' bailout packages.

Emerging Markets

Despite being the cradle of the COVID-19 outbreak, China has seen its stock market outperform both developed and other emerging markets by a large margin. Being first in, and potentially first out, of the crisis might well have been a benefit, alongside its harsh lockdown measures, which were observed more strictly than in the West. Policy response has also been aggressive in terms of fiscal stimulus, freeing up bank capital and cutting the seven day repurchase rate. Once again, predictions of China's demise have not come to pass. However, it is clear that future rates of growth will continue to decline even once the virus effect has passed. We continue to believe that more sustainable slower growth is no bad thing.

Fixed Income

Once again, government bonds have proved their worth as "insurance" assets, providing positive returns during the quarter. However, we have pointed out for a while that with yields being so low, the only meaningful returns one can achieve are from capital gains, and that becomes ever harder as yields head towards zero. UK and US 10-year yields are 0.3% and 0.6% respectively now, well below any future expectations for inflation (and certainly below central banks' aspirational 2% inflation target). German Bunds, starting the period with a yield below zero, held their value, at least, but failed to provide much compensation for falling equities. With the US Federal Reserve, for now, drawing the line at zero in terms of its base rate, it is questionable how much more juice there is to be squeezed out of the 40-year Treasury bond bull market. Possibly no more than a few drops.

Where to head for higher returns? Inevitably that requires investors to take more risk. For those looking for an insurance policy that will pay out if equity markets fall owing to weak economic conditions, one would head further down the maturity curve where yields are higher. This longer-dated route still promises capital gains if yield curves flatten further, but the longer duration means higher volatility.

For substantially higher income, corporate bonds look more attractive, and following recent market moves, we now see value re-emerging in credit, where yield spreads have widened considerably owing to the risk of increased defaults. Central banks are providing a liquidity backstop to the Investment Grade market, and even in High Yield there is some belief that governments will not want too many companies defaulting or filing for bankruptcy with all the job losses that would entail. Equity holders will bear the brunt of the pain.

UK Gilts have delivered a total return of 6.01% over the last three months and 9.94% over the last year. Index-Linked Gilts returned 1.7% and 1.61% over the same respective periods. Emerging Market sovereign bonds produced a total return of minus 5.6% in sterling over the three months to end March (+0.23% over 12m). Global High Yield bonds delivered minus 5.6% (-3.61% over 12m).

Conclusion and Outlook

These are challenging times, but, as always, we rely upon our tried and trusted investment process to guide us. Our preference for companies with sound balance sheets, high returns on investment and the ability to compound those returns for years ahead has helped to contain the damage. Holdings in uncorrelated assets such as Gold (or equivalents) and selected hedge funds has also helped within a balanced portfolio structure. As we transition into the second quarter we are already seeking out new opportunities where market dislocation means that there is a meaningful gap between current market value and intrinsic value.

We would argue that the biggest structural risks to the market have peaked, given that forced sellers have exhausted much of their supply and also because governments and central banks have once again played the "whatever it takes" card. However, cyclical risks remain, and we need to see more evidence of a flattening of the curve of new COVID-19 cases as well as a clearer view of the damage to the economy and corporate profits before taking on more risk in portfolios. It is also worth bearing in mind that the world economy's own immune system is now weak. It was just recovering from the trade war before the coronavirus outbreak – and then the collapse in the oil price, thanks to a price war between Saudi Arabia and Russia, was another unwelcome blow. We can ill afford another extraneous shock now.

I am sure that there are several issues that have not been covered to everyone's satisfaction in this report owing to word-count constraints. We encourage you to contact us with any further questions you might have. After all, what better time to show the value of a service and advice based business than in times of crisis.

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Out of the Ordinary