Weekly Digest

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John Wyn-Evans
Head of Investment Strategy

Balancing Act

If anyone had followed the old stock market adage to “Sell in May” at the beginning of last month, they might now be feeling a little regretful. Global equities, as measured by the MSCI All-Countries World Index, having gained 10.6% in April, put on another 4.2% in May, and now stand 32.6% above the low point reached on March 23rd. Given that the news continues to be filled with gloomy bulletins about the effects of the coronavirus on our lifestyles, the economy and government finances, not to mention rising political tensions, this apparent burst of optimism might seem surprising to many, but it is not difficult to rationalise. The big question, as ever, is whether or not it will turn out to be correct.

Investors are balancing a pile of different influences in order to reach their current conclusions. Some are more familiar, such as the analysis of company performance and the valuation placed on that. Then one has to factor in monetary and fiscal policy, which, although also familiar, is currently being stretched to hitherto unknown levels. Investor positioning and liquidity appears to be another driver of the recent moves. Last, and certainly not least, there is the small matter of Covid-19, probably the biggest “known unknown” of our times. Let’s look at them in turn.

On the company front, we are still working through the exact ramifications of the lockdowns, but the market, following the plunge in March, initially moved pretty quickly to sort out the sheep from the goats. Companies that were going to be most badly affected by the lack of activity were pummelled, while those whose sales were going to be relatively resilient recovered. The shares of companies whose business models were actually going to benefit from the lockdowns went into overdrive. One particular example in the UK has been Ocado, which these days positions itself as a logistics and distribution technology company rather than a food delivery service. Its shares are currently trading around 60% above pre-virus peaks. Another example is a company whose name has become a verb in its own right – Zoom. Its video conferencing application has become so popular that the shares have risen 164% this year (although I must admit that I know few people who are actually paying for its services). At the other end of the scale, if we look at large companies in the FTSE 100 Index, many of the big losers are involved in the travel industry, with the shares of Carnival (cruises), IAG (the holding company for British Airways and Iberia), easyJet, Rolls Royce (jet engines), Melrose and Meggitt (aircraft components) all falling by 50% or more.

More recently though, there are signs that market leadership is changing. As investors become more confident that they have identified the trough of economic activity, which now appears to have been passed in April during the period of maximum lockdown, they are looking more to the recovery phase. The FTSE 100 Top 10 for May includes easyJet, as well as the three major Mining companies, Rio Tinto, BHP and Anglo American (although Ocado still tops the monthly chart). The one-week list of best performers is even more concentrated in cyclical stocks. This is the sort of rotation typically associated with the recovery from recessions and may well have more legs over the summer. Even so, we will remain very selective in participating in such a rotation, bearing in mind our longer term preference for companies with more resilient and durable growth characteristics.

Looking at the fiscal and monetary impetus, it cannot be described as anything other than positive. In today's editorial, even the normally conservative Financial Times is urging governments to borrow as much money as they can, at low interest rates with long maturities, and to spend it supporting the economy in its time of need. Austerity has been consigned to the policy dustbin for the foreseeable future. And bond markets are compliant, thanks to central bank purchases and a surfeit of household savings. The 10-year UK Gilt yield, at 0.19%, is hovering just above its all-time low. Even borrowing money for as long as thirty years costs a paltry 0.58%. And the UK already enjoys a remarkably long average maturity of over fourteen years for its debt, leaving plenty of time to create some growth to start paying it down. Of course, those low yields present their own problems for investors, more on which later. In Europe, there has been an uncharacteristic outbreak of unity between France and Germany in creating an EU-wide fiscal package worth €750bn (with the caveat that it hasn't quite got over the line yet thanks to the usual objections from a group of more frugal northern members of the EU).

Central banks are "all in" policy-wise, with all of their leaders committed to doing "whatever it takes" to ensure that economies recover. Asset purchases are at record levels, even embracing riskier assets than during previous policy cycles. Perhaps the most extraordinary development is that neither the US Federal Reserve nor the Bank of England are any longer ruling out negative interest rates, a phenomenon that already exists on the Continent. Theoretically this would mean paying the bank to look after your cash (rather than receiving interest), although, in practice, banks in Europe have been reluctant to inflict this upon retail depositors. It could also mean the bank paying you to take a loan. However tempting that might sound, it is indicative of an economy that is extremely unwell, and neither is it conducive to the banking industry's profitability, something that is a prerequisite for a properly functioning lending market.

All this lack of yield and income on safe assets such as government bonds and cash leaves investors searching for better returns in "riskier" assets, with risk, in this case, being defined as volatility. Thus more cash finds its way into shares, corporate bonds, real estate, etc. As we have observed in the past, those low bond yields also set a low discount rate for valuing assets such as equities, leading to higher present valuations, especially for faster growing companies. Meanwhile, it looks as though a lot of investors, both private and professional, hit the panic button in March and found themselves holding too much cash in a rising market, leading to underperformance. They are being dragged, however reluctantly, back into the market as it rises for fear of missing out on further gains.

Covering those three broad factors, you might think that we should be unmitigated bulls of risk assets. However, we are unsettled by a few things. Not least is the sheer lack of certainty around the progress of the SARS-CoV2 virus. The learning curve remains exceptionally steep. Certainly the news in terms of the growth of infection and fatality rates in most western economies is encouraging, but it continues to deteriorate in many emerging economies, notably Brazil. Relaxation of lockdowns has so far been relatively successful in terms of further outbreaks. Nobody yet knows if this is related to seasonal factors, but there is some evidence that outdoor activity is less risky. But it is also clear that social distancing measures will continue to restrict indoor activity, ranging from manufacturing and office work to hospitality and retail. What's going to happen when it starts raining again? (I think we have had two showers and one proper soaking in the last ten weeks in London). Yes, activity is recovering from the lows, but we are a long way from returning to business as usual.

Hope for a vaccine remains the greatest cause for optimism, and, in some ways, I've never wanted to be more wrong on anything than this. An effective vaccine would stop the virus in its tracks, which would be tremendously positive, but the history of vaccine development suggests caution, even if we acknowledge scientific progress and the amount of financial and intellectual power being thrown at the problem. There are three key obstacles to overcome. The first, and in some ways easiest, is efficacy. The science of blocking pathways for viruses is well advanced, even if coronaviruses present their own special problems, which is why no vaccine has ever been developed for those that already exist. There again, none of its predecessors have presented quite the same risks as the current one. The second obstacle, safety, is far harder to overcome. In taking out the invader, you don't want to kill the host. Safety is the main reason why so many experts in the field remain cautious about the timeline for a vaccine being widely available. There is credible evidence, for example, that Pandemrix, a vaccine for H1N1 flu, triggered a sharp rise in the number of children in Finland developing narcolepsy. Antibody-dependent enhancement, which actually worsens the effects of the virus, is another potential problem, and one that has scuppered attempts to create a vaccine against the Dengue virus. And even when we overcome those obstacles, the vaccine has to be manufactured and distributed on a previously unattempted scale. While I am more prepared to believe that the logistics can be managed with money and willpower, whether everyone can be forced to comply is another question altogether. A YouGov poll in the United States (reported by the BBC) "suggests that 28% of Americans believe that Bill Gates wants to use vaccines to implant microchips in people – with the figure rising to 44% amongst Republicans". And that's not counting other "anti-vaxxers". That might make reaching herd immunity somewhat more challenging.

I haven't even mentioned geopolitical factors, such as the escalating tension between the US and China, China's imposition of new laws on Hong Kong, and, of course, Brexit, none of which are on the positive side of the ledger, and which could all merit their own Weekly Digest. No doubt they will soon enough. Wrapping all this up, we kept our risk weighting at neutral at last week's Asset Allocation Committee meeting. We will need either more compelling value (as we found in March) or more visibility on the virus/vaccine front to become more positive. To be more negative we would have to expect worse "second round" effects of the lockdowns, and possibly signs that investors were losing their faith in the ability of finance ministers and central bankers to keep the plates spinning (especially if there was a second spike in the virus combined with limited progress on the medical front).

Last week’s Economic Highlights

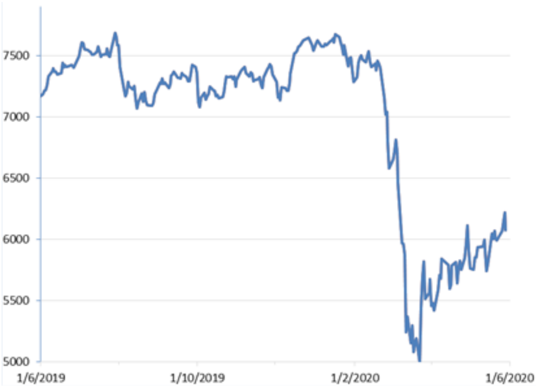
FTSE 100 Weekly Winners

TUI AG	47.2%
Melrose Industries	24.5%
Whitbread	19.6%
easyJet	18.3%
British Land	15.9%
Rightmove	12.6%
Standard Life Aberdeen	12.0%

FTSE 100 Weekly Losers

HSBC Holding	-7.2%
Prudential	-6.1%
Standard Chartered	-5.9%
AstraZeneca	-4.3%
Rolls-Royce	-4.1%
Imperial Brands	-4.0%
London Stock Exchange	-3.7%

FTSE 100 Index, Past 12 Months



Source:FactSet

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