Weekly Digest

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(Not The) Status Quo Ante

Apparently the Romans had no pithy phrase to describe the return to a situation that wasn't the same as it was before - for example, after a war. In the modern world we have seen the use of "new normal" becoming more widespread in recent years. Whatever words we use to describe life in the aftermath of the Covid-19 lockdowns, it is becoming increasingly clear that many aspects are going to be very different for a considerable period of time. It is the extent and effect of these changes that investors are grappling with as we appear to be moving into the next phase of markets' reaction to the outbreak.

Very broadly, there have been four distinct market phases so far this year, following a roughly monthly cycle. In January we saw the first concerns emerge from China about a novel coronavirus, with investor worries focused primarily on supply chains. By the middle of February, some equity markets were hitting all-time highs as the virus was judged to be relatively well contained, while at the same time falling bond yields were the justification for higher equity valuations. During March the world woke up to the prospects of a global pandemic, which culminated in a selling frenzy across all asset classes irrespective of their theoretical exposure to the risks. This gave way in April to a powerful rally in which there was a large performance dispersion between, on the one hand, resilient "all-weather" businesses and companies deemed to be winners from enforced lifestyle changes, and on the other, those facing existential challenges.

So what comes next? Tempting as it might be to fall back on the old "Sell in May" stock market adage, we need to be more scientific. Indeed, science, in its broadest sense, will be responsible both for shaping society's return to increased levels of activity and for delivering the medical solutions that are essential for full participation. It is no surprise that markets have been highly sensitive to any breaking news about cures and vaccines. However, everything that we have learnt about the development of vaccines suggests that nothing will be forthcoming until the end of this year at the earliest, especially when one accounts for the logistical challenges of manufacturing, distribution and delivery. That means close to a full year of severely restricted economic activity, at least.

In the early stages of the crisis, there was much hope of a "V"-shaped recovery, but that is becoming less probable by the day. We are already beginning to see what are described as second order effects. If the first order is the immediate drop in activity caused by the lockdowns, the second order is the fallout from those, and one industry where this is becoming especially evident is travel. Several airlines, including BA and Ryanair, have already announced job cuts, and the pressure is also being felt in aerospace, with Boeing, Airbus and Rolls Royce (the jet engine manufacturer) all planning to make staff redundant too. The High Street and shopping malls might also look a bit different when we finally return there, with Oasis and Warehouse the latest brands to announce permanent closure. Although that might be good news for the survivors able to pick up

market share, it is hard to see those made redundant waltzing back into employment.
I am aware that there is a more positive argument for pent-up demand to trigger a surge in consumption at some point, and there is some logic to that. Savings ratios rose sharply in the first quarter, notably amongst the rich and the old. But it's not entirely clear where that money will be spent. If restaurants and bars are mandated to operate at 30% capacity, and sports arenas, concert venues and cinemas potentially remain closed, there's only so much more gin we can drink at home. You can watch Netflix for twenty-fours every day and it won't cost you a penny more than if the TV remains off. Whatever boom there might be in "staycations", that will not be enough to offset the lack of overseas tourists (who also tend to spend more) entering the country. As for returning to work, with all the extra spending on travel, food, suits, shirts, etc that might generate, I am working on the basis that I will be manning the Hackney office for a few months yet. (Interestingly there is a wide spread of opinion within the Research team for when the office will re-open to any meaningful extent. It ranged from mid-May to December at the last count).

From a market perspective, then, I can see four potential outcomes over the next few months. 1) Good news (low probability): a vaccine is discovered and made available within six months. Risk assets would rise strongly, supported by excess liquidity, with a huge rotation into cyclicals and value stocks; 2) More of the same (medium probability): we just keep muddling through with a gradual exit from lockdown and no big surprises; 3) The grind lower (higher probability): there is a growing realisation that the return to normal is very slow and with increased risk of second order effects. There is potential for markets to revisit the March lows, with investors also selling winners because that's where they have profits; but the focus on recovery in 2021 combined with open-ended policy support will limit the damage; 4) The disaster scenario (low probability): The virus keeps returning aggressively as soon as lockdowns are relaxed, and so we have to re-enter full lockdowns. A liquidity crisis morphs into a proper solvency crisis. And some mad stuff from Trump is the icing on the cake.

None of these outcomes is a firm prediction, but it helps to think through the range of possible outcomes when it comes to balancing a portfolio.

Bearing all of this in mind, our most recent move, driven by meetings of our Asset Allocation Committee and Global Investment Strategy Group, has been to take a little risk off the table again, reversing the increase that was recommended in March. We don't usually move so fast, preferring to concentrate on the longer term, but these are exceptional times with exceptional market volatility.

To end on a brighter note, one feature of April was the relatively normal functioning of the corporate bond market, a testament to the decisive action of central banks. Although the focus of news headlines tends to be on the equity market, the lion's share of the corporate sector's capital requirement is raised through the bond markets. As we saw during the Global Financial Crisis, when these gum up, so can the whole financial system. Even so, debt does not come cheap, with interest rates sharply higher for stressed borrowers than they were last year, and so this extra liability will have to be accounted for. And there are borrowers that represent both ends of the spectrum when it comes to the winners and losers of Covid-19. Both AMC (an American cinema chain facing an existential threat) and Netflix tapped the market for funds in April. Let's hope they both thrive in the future, for the good of bondholders and our entertainment options.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Centrica	21.4%
Micro Focus International	21.2%
Carnival	18.1%
Barclays	15.9%
Ashtead Group	15.3%
John Wood Group	12.1%
Flutter Entertainment	10.3%

FTSE 100 Weekly Losers

Royal Dutch Shell Plc Class B	-11.0%
Royal Dutch Shell Plc Class A	-10.7%
GlaxoSmithKline	-4.5%
Rio Tinto	-3.6%
Sainsbury	-3.5%
Fresnillo	-3.5%
Intertek Group	-3.2%

FTSE 100 Index, Past 12 Months

Source:FactSet

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