# Weekly Digest

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## Immune Systems

The new week has delivered another nasty shock for investors, with many equity indices falling into bear market territory at the open. It seems extraordinary that only thirteen trading days ago the S&P 500 Index in the United States hit an all-time high. It could shortly register a 20% fall – the generally accepted, although somewhat arbitrary, definition of a bear market – faster than the current record dating back to 1929. That would no doubt have the panic merchants predicting crashes and depressions to match the end of the roaring twenties, but we continue to believe that such pessimism is misplaced.

I have noted before that the role of an investment strategist these days seems to be as much about explaining what just happened as about forecasting future developments, and today provides just such a moment. We have commented in the past that the structure of economies and markets today make them more vulnerable to volatility spikes and what one might describe as “air pockets”. There are multiple reasons. First of all the interdependence of financial markets and the real economy is far greater than in the past owing to the record levels of debt. Challenges to consumption, such as we are seeing created by the reaction to the coronavirus, can quickly lead to financial stress for highly leveraged companies or those with onerous short-term obligations such as salaries, rent and business rates. The inability to access or refinance credit facilities can push weaker companies over the edge.

Second is the ownership structure of markets, with more assets than ever being allocated to Exchange Traded Products, computer-driven models and funds that are forced to adjust their risk weightings according to movements in volatility indices. We have also witnessed the negative effect of option hedging requirements as indices have fallen through certain levels. To make matters worse, computerised trading platforms tend to have much less depth, meaning that the process of price discovery can be highly uncertain. My favourite analogy for this is the fire alarm scenario. In normal circumstances a room full of people can evacuate reasonably quickly through even a small exit door in single file. But if everyone tries to get out at the same time nobody leaves because the door gets blocked.

All of this happens for a reason. Today we have a striking new factor introduced on top of the virus malaise (which has itself increased over the weekend with more cases and containment strategies announced), and this is an extraordinary fall in the oil price, which amounted to over 30% at the start of trading. Again, it’s hard to believe that just two months ago, with missiles flying around the Middle East, the oil price spiked to more than $70 per barrel. It is now around half that level. The reason for the collapse is a disagreement over production cuts between Saudi Arabia and Russia which has triggered a price war between the two.

How much of this is the result of an opportunistic attempt by Russia to undermine the finances of the US shale oil industry is open to debate, but cold logic suggests that neither country is in a position to bear such low prices for a sustainable period.

Therefore, as with the coronavirus, the effects should be relatively short-lived. However, there will be casualties amongst more financially challenged producers. This will show up again, as it did in 2015/16, in the US High Yield bond market, which has a double digit percentage exposure to oil exploration and production companies, and will undoubtedly have a knock-on effect through the asset class.

Thus we are faced with two quite separate short term factors which have combined to send risk assets into a tailspin. If we think of COVID-19 and its ramifications as having lowered the markets' and investors' immune systems, the oil price shock is akin to an opportunistic infection that has had a much worse effect than it would in a healthy patient. To some degree we can only hope that another factor does not emerge imminently. Even if we continue to believe in some sort of "V"-shaped recovery, it's not proving easy to determine where the bottom of the "V" lies. And it might be a "U".

One area in which we remain reasonably confident that the right thing will be done is policymaking, despite the retreat of global co-operation in recent times. We have already seen a few central banks cut interest rates and more will follow, even if there has been widespread criticism that cheaper money will not reverse a demand shortfall if we are all in lockdown. But, in that it alleviates some potential financial stress, it was the right initial move. Now it is incumbent upon governments to provide support. The key initial policy must be to throw some sort of lifeline to cash-strapped smaller businesses. This could be done by allowing (ordering?) banks to be more lenient on unpaid interest or by announcing a moratorium on, say, tax payments or business rates. I'm thinking out loud here, but don't rule anything out. No government will want to be accused of not having tried.

On the consumer side of the equation I would not be at all surprised to see, for example, a temporary reduction in the rate of VAT or some kind of polluting vehicle trade-in payment – both of which were used to boost demand following the financial crisis. Some countries might follow the examples of Hong Kong and Thailand, both of which have handed cash lump sums to citizens – the closest thing to "helicopter money" we have seen so far. A UK 10-year Gilt yield of less than a tenth of one percent as I write makes for very cheap financing. Yes, I acknowledge that it risks piling up future sovereign liabilities, but let's at least get to the future in one piece first.

Moralising about the virtue of any policy response will almost certainly mean failing to take advantage of what is offered, at least in the short term. Long-term portfolios can be constructed to mitigate whatever risks might ensue.

There is no doubt that, in retrospect, we could have taken more risk off the table earlier in the year, but our overriding investment stance is based on an eighteen month view, and we have always considered the coronavirus effect to be in the "short, sharp shock" category (and the same for the oil price now). At least we did not compound the error by leaning back into risk assets too early. Even so, from a tactical asset allocation perspective, it does feel as if the next move might well be to add more risk and to take advantage of fire sales. Our Dividend Discount Model for Developed Market equities (which is based on S&P 500 trailing dividends and current US bond yields) suggests that markets are now 33% cheap relative to bonds. History suggests that a 25% (one standard deviation) value gap provides a compelling long-term buying opportunity. Of course, such models cannot guarantee perfect timing, but they might just reduce the risk of selling when things are at their worst.

# Last week's Economic Highlights

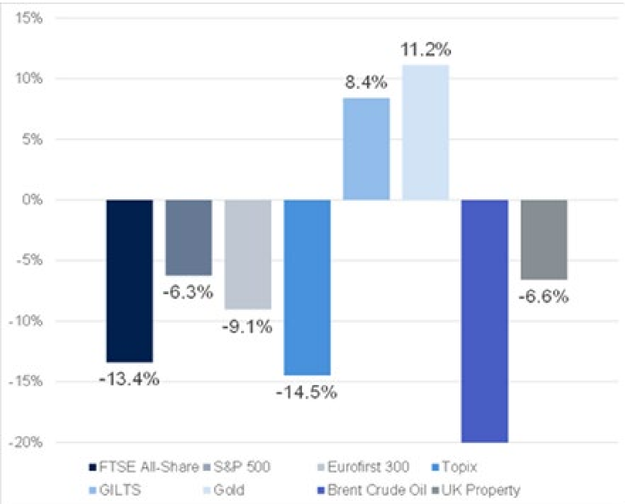
## FTSE 100 Weekly Winners

| | |
|---|---|
| Fresnillo | 9.8% |
| Wm Morrison Supermarket | 8.2% |
| J Sainsbury | 7.8% |
| AstraZeneca | 6.6% |
| Halma | 6.0% |
| Imperial Brands | 5.6% |
| Ocado Group | 5.5% |

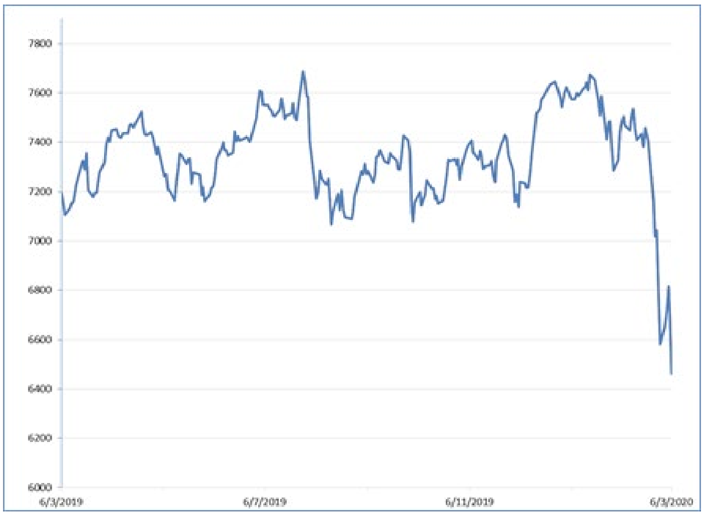
## FTSE 100 Weekly Losers

| | |
|---|---|
| Carnival | -18.6% |
| EasyJet | -17.5% |
| Informa | -12.7% |
| Melrose Industries | -12.7% |
| ITV | -12.2% |
| John Wood Group | -12.2% |
| Royal Bank of Scotland | -12.0% |

## Year to Date Market Performance




## FTSE 100 Index, Past 12 Months




Source:FactSet