Weekly Digest

| 23 March 2020 |

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End Game

My final social engagement a couple of weeks ago was a trip to the theatre to see Samuel Beckett's Endgame, a play in which the characters are trapped in a box-like room to contemplate a fate that (in true Beckett style) never materialises. Their confinement appears to be the result of some sort of apocalyptic event. Little did I think that two weeks later I would be similarly confined to my home, with the streets outside eerily devoid of the usual tidal flows of humanity. These are extraordinary times, and trying to make sense of them in terms of financial market analysis is proving to be a challenge.

I am taking a three-pronged approach to the situation. The first thing we need to monitor is the medical situation. It has become clearer in the last week that, from a policy perspective, saving lives takes precedence over economic activity. Thus we are experiencing ever more draconian measures aimed at "social distancing". I explained a few weeks ago that the pattern of epidemics tends to follow an "S-curve". One sees a relatively slow initial build-up of cases, which then accelerates rapidly before flattening out again as counter-measures take effect. We can already see this pattern playing out if we follow the virus from its beginnings in China. Containment measures in China itself mean that the province of Wuhan has not reported any new cases in the last four days. Indeed the majority of new cases in China appear to have been brought back into the country be returning travelers. This, and similar shaped curves in places such as Singapore, Hong Kong and South Korea, provides some comfort that containment is a viable strategy.

Unfortunately, the rest of the world is several weeks behind China in terms of the spread of the virus and also in taking measures to contain it. Thus we have, in all probability, yet to experience the steepest part of the curve here in the UK; certainly so in the world's most important economy, the United States. The same will be true of many other countries. This means that the worst is yet to come in terms of reported new cases and deaths. To exacerbate the situation, there remains much uncertainty about mortality rates, mainly because, owing to the lack of testing capacity, we have no idea how many people have actually had this virus. We are monitoring the daily data by country to watch for any signs of a deceleration in the infection rate. There will be some relief when that is seen in the core European countries, especially Italy. Developments in the US will also be key to restoring confidence.

However, any return to what we might consider normal will not be immediate. We have already seen new clusters of infection in South Korea, for example. There is likely to be some system of "dynamic social distancing" that remains in place either until a vaccine is developed or until sufficient herd immunity has been acquired. This will continue to weigh on general economic activity for some time.

The second area of focus is the financial system, which has definitely been creaking over the last couple of weeks. As we saw during the financial crisis, the world cannot cope without a functioning banking system, and central banks have thrown all their resources into ensuring that this does not seize up again. That's not to say there have not been stressful moments. The overnight repurchase market has struggled to cope with the demand for dollar cash as both companies and banks hoard funds. Asset markets have seen days when it has been difficult, if not impossible, to sell anything at a remotely sensible price. On the more extreme days we have seen supposedly "safe" assets falling in value because they were the only things that could be sold in meaningful size to raise funds. Some of this was down to forced deleveraging by funds that manage portfolios based on the level of volatility. With the VIX Index hitting an all-time high last week, they had no choice but to reduce positions across the board. There is some evidence that the worst of that particular phase of selling pressure has now peaked, at least, but redemptions and margin calls will continue to weigh.

Then there has been governments' response to the crisis. We have seen all sorts of extraordinary measures announced with commendable speed, ranging from payment deferrals to cheap loan facilities and cash handouts. It is inevitable that fiscal deficits will rise sharply, but it is generally accepted that this is a price that has to be paid. What will be intriguing is to see the extent to which central banks and governments work together. Since the financial crisis, measures such as Quantitative Easing and zero interest rates, which were seen as temporary remedies, have become more permanent. It is possible that direct purchases of government debt by central banks will now become the norm. Once debt is "monetised" in such a fashion, it has major implications for how money itself is valued, which might well lead to very different types of portfolio construction in future.

The key point to make, though, is that no measure will be deemed too extreme or too costly in the short term to keep the financial system functional and to ensure that the private sector is provided with some sort of safety net to compensate for the enforced lack of activity. I have deliberately not provided exact numbers because they are virtually meaningless and will also be subject to frequent revisions. Suffice to say that the words "whatever it takes" will be repeated often. There will be bumps in the road, as we saw last night is the US, where the Senate was unable to agree on a package of supportive measures. I can assure you that they will once they acknowledge just how bad the situation is, much as they did in 2008.

The final pieces of the jigsaw are economic growth and company earnings, and here we are subject to the greatest uncertainty. Within the investment bank and independent forecaster communities there is something of a race to the bottom in terms of expectations, with every day bringing a new low. The speed of decline will be unprecedented. For example, in the fourth quarter of 2008 following the bankruptcy of Lehman Brothers, the US economy shrank by an annualised 8%. Goldman Sachs suggests a figure of -24% for the second quarter this year, while one member of the Federal Reserve Bank has ventured -50%. These figures were inconceivable just a few weeks ago. And although there will inevitably be a sharp rebound in activity, the trajectory of the recovery is hard to predict. It certainly feels that hopes for a "V" shaped recovery are too optimistic.

From a company perspective, it is clear that earnings could, in aggregate, by wiped out for a quarter or longer, although there will be a huge gap between the haves and the have nots, one which investors are already anticipating to judge by the relative performance of different stocks and sectors. Our key principle has been to remain invested in companies that will at least be able to survive the downturn and thus benefit from the recovery. There will be a time to consider more risky situations, but definitely not yet.

We often remind investors that dividends are the least volatile component of investment returns. That will be the case again, but the overall level of dividend payments is going to be significantly curtailed this year and potentially next as well. We have already seen dividend suspensions from companies such as Marks & Spencer and Intercontinental Hotels Group, both viewed as being in decent financial shape prior to current events.

But we remain far from despair. According to data from Goldman Sachs, the UK stock market trades at the 11th percentile of its price-to-book value since 1965 (and so has been more highly valued on this metric 89% of the time over the last fifty-five years). Unless we believe that the ability to generate a reasonable return on capital has been permanently impaired – and we don't – then investors will able to take advantage of some long-term opportunities once we have some greater clarity on the short-term pain.

Last week's Economic Highlights

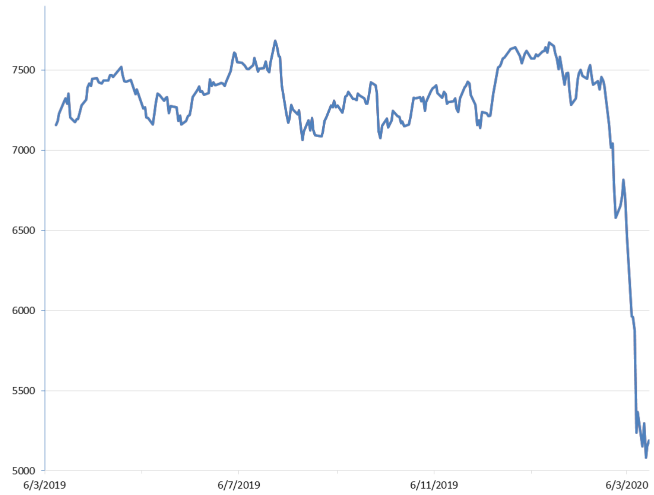
FTSE 100 Weekly Winners

Sainsbury	14.9%
Ocado Group	13.6%
BT Group	12.3%
Reckitt Benckiser	12.1%
Royal Mail	11.7%
DCC	11.0%
Marks and Spencer	10.6%

FTSE 100 Weekly Losers

IAG	-38.3%
John Wood Group	-34.2%
Melrose Industries	-28.9%
ITV	-25.2%
Rolls-Royce	-25.1%
Informa	-24.8%
EasyJet	-23.7%

FTSE 100 Index, Past 12 Months



Source:FactSet

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