Q2 2020
OUTLOOK

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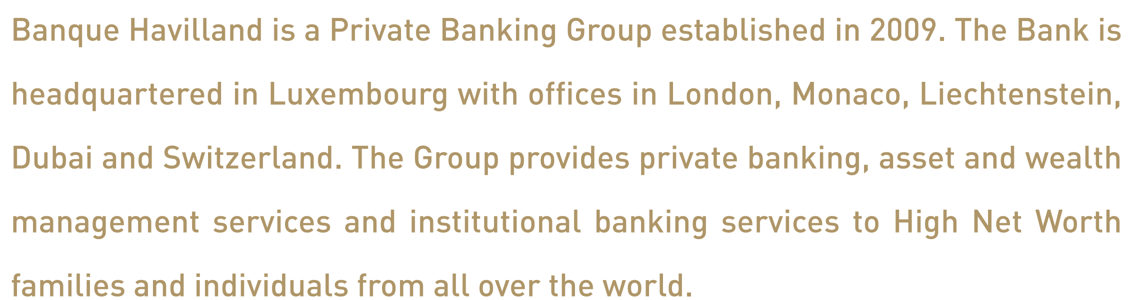

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MARKET ENVIRONMENT

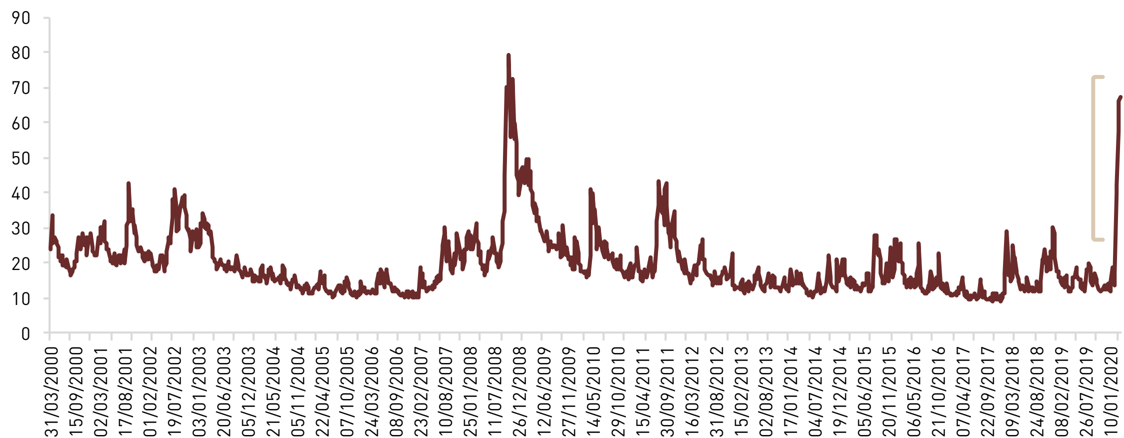
The worst Virus panic may be behind us, but the **longer term ramifications are unknown**

Attempting to offer short-term or even medium term guidance to the direction of markets in the midst of the Covid-19 crisis, is something of a fool's errand, and even if we can take comfort from the fact that the virus will eventually subside, predicting any sort of timescale for a recovery would be guesswork at this point. The capitulation of global assets over the past few weeks has been shocking even to those of us working in the markets during the 2008 financial crisis, and as is the tendency of humans in needing to establish reason and explanation to unforeseen events – several theories have been put forward to make sense of the carnage: overvaluations of the large parts of the equity markets; low interest rates and the policies of central banks since the last crisis; the overreach of the globalisation and the subsequent reversal; or the vast amount of debt in the financial system. All these points are important long-term themes and any one of them could have triggered a correction in their own right, but the simple truth is the coronavirus and the global response to it has caused a sudden and severe economic demand shock, the depth of which is currently unquantifiable and the repercussions of which could yet change the financial system as we know it. We are of the view that the initial violent sting that saw a 30% +drop in global equities in less than a month has passed, along with the extreme volatility that accompanied it – with this sting effectively representing investors expressing their shock that the virus news-flow escalated, and now we would not be surprised to see a more 'orderly decline' as market participants weigh up quite how severe the ensuing downturn will be.

Stocks are forward looking and tend to quickly price in any new developments, and a 30% drop would ordinarily suggest that the bulk of the dire expectations have been reflected in prices already.

Going into 2020 we had been more positive on financial markets than we had in some time (though still cautious), following the UK election, the prospect of fiscal stimulus, and the expectation that trade tensions would settle heading into an election year – clearly this thesis is now in tatters as we, like all investors find ourselves licking our wounds and reassessing the state of play. There is always room for optimism and while we are far from encouraging adding risk to portfolios in general at this point, there are clear parts of the market that now look very cheap and should be of interest to those with longer term investment horizons – the stock market will surely find a bottom before the virus has finally gone, and the price of oil that looks set to be significantly lower following the Saudi action could help grease the wheels of a recovery.

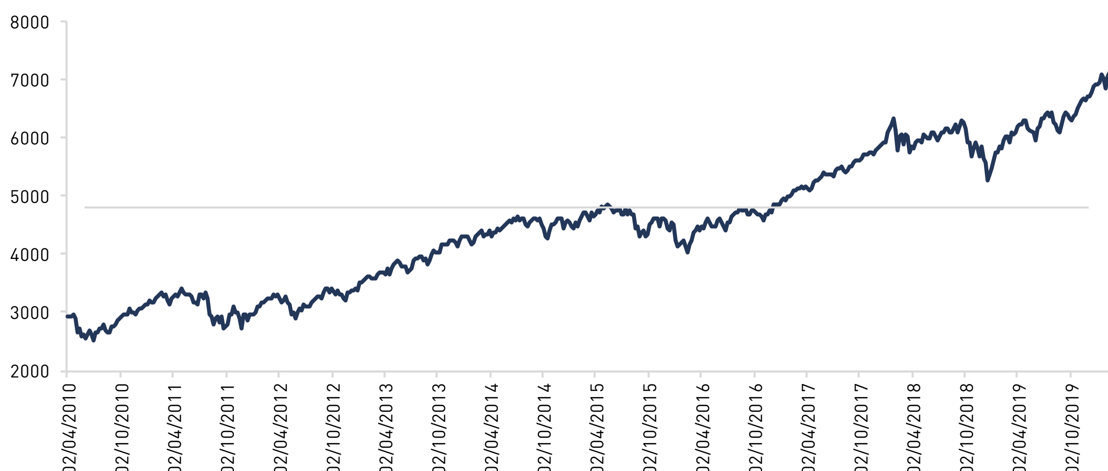
CBOE VIX Index (Volatilty Measure)



Volatilty in the equity market spiked remarkably in the midst of the Coronavirus crisis, but has since dropped a little, hopefully signalling the most severe selling has ended. (source: Bloomberg)

How lasting the downturn will be, depends largely on how quickly the 'peak' of the virus (in terms of new infections, deaths and recovery rates) is seen to have been passed – with the key metric here being the rate of unemployment. Key to this will be the spread of the virus in the USA, as the 'last' developed market to be hit by the disease, and of course the world's leading economy, any signs the spread is not under control could see a protracted decline in markets – though the wildcard Presidency's approach to containment (Trump has indicated his desire that he is not willing to shut down the US economy for any length of time, in contrast to other world governments) could be crucial. The Central banks and governments around the world have thrown the proverbial kitchen sink at their respective economies, with each measure announced being increasingly surreal in scale and number, however, with large swathes of industry ceasing to operate at all, growing unemployment will become inevitable and the demand shock exacerbated despite the stimulus. Therefore the longer the virus lingers, it follows that economic activity will decline further with unemployment increasing, along with the shoots of recovery stymied with those out of work take time to re-join the workforce. There is also the threat that even once the first wave of the virus is controlled, that it re-emerges once the containment measures are lapsed, triggering another wave of uncertainty in global markets. In recent years we have become used to seeing the promise of central bank action underwrite anything that could potentially derail the bull market, so the spectre of such vast amounts failing to buoy markets this time has been especially alarming. Quite simply, money cannot cure a pandemic, nor can zero interest rates – all they can do is soften the blow and encourage the recovery once it comes. The economic recovery is likely to be slow, but that does not necessarily preclude the move in asset prices from being swifter. One thing is for sure and that is that the economic data will be dire for all the nations imposing lockdowns for any length of time, with GDP growth clearly set to be severely chopped, in many cases expected by an excess of 10%, though worse figures than this would be no

MSCI World - 10 years



Global equities have sold off sharply - over 30% from their peak. We note, however, that the drop has stalled at the 10 year average level. (source: Bloomberg)

great surprise. Unlike the great financial crisis, which seemed to threaten the end of the financial world, this crisis feels particularly curable (scientists seem to estimate a vaccine between 6-18 months). We may have a couple of quarters of down GDP, but the potential rebound should be far closer than in an average recession. It remains to be seen how effective the various nations' rescue packages will be in practice – it is one thing to declare 'no company of any size will be allowed to go bankrupt' (Emmanuel Macron) and 'whatever it takes' (Mario Draghi, latterly Rishi Sunak), and another to mobilise the state to actually ensure the cash gets to the intended beneficiary! Seeing how comparatively minor adjustments to benefits payments or pension reforms have caused operational problems for the state (at least here in the UK) it is easy to see why markets are yet to be satisfied that governments can back up their rhetoric with action. The enormous cost of these rescue packages will almost certainly result in ultra-low yields and official rates near zero for the next decade. In the years to come, we could well be looking back at this current period as the best entry point for many years.

There is a worry that once the virus does pass, the measures taken to see it off will have far reaching consequences that may do more damage to the world's economy than the disease itself. Strangely, some of the themes that have concerned us for some time have been brought to the fore by the virus outbreak and the global response to it. In last quarters' outlook we brought up the subject of Modern Monetary Policy (MMT), the likelihood of long-term frictions between the US and China, and crucially for investors the prospect of resurgent inflation as future issues we would need to grapple with. Even the strongest proponents of MMT would not have envisaged this happening in 2020, let alone conservative governments around the world promising to literally underwrite private sector salaries directly in March of this year, and while ostensibly such policy is supposed to be temporary, we know how difficult it is for politicians to reverse even the smallest spending commitments. Helicopter money is here, and is a giant

experimental financial medicine that may soften the growth impact of the virus, though with painful side-effects. Government spending on such a vast scale does not guarantee that inflation will reappear of course, but we would not bet against it either once employment levels recover from the virus-induced slump. Finally, the virus has already exacerbated tensions between the US and China that had started to wane prior to the outbreak, with increased politicisation of the issue coming from both sides and we expect this to be a recurring geopolitical theme in the years to come, that has been brought forward ahead of our initial estimates. It is quite possible that many global supply chains and networks will be reset as nation states are reminded of the importance of borders when crisis breaks out. As the immediate future is uncertain in terms of how long it will take to beat the virus, and the 'cure' also posing longer term structural questions we can only really plot a course to allocate assets over the medium term (that is 3-5 years), which actually is not that dissimilar to any given point in time. The basic tenets of investing remain the same: hold assets that are structurally sound where the risks are fully understood.

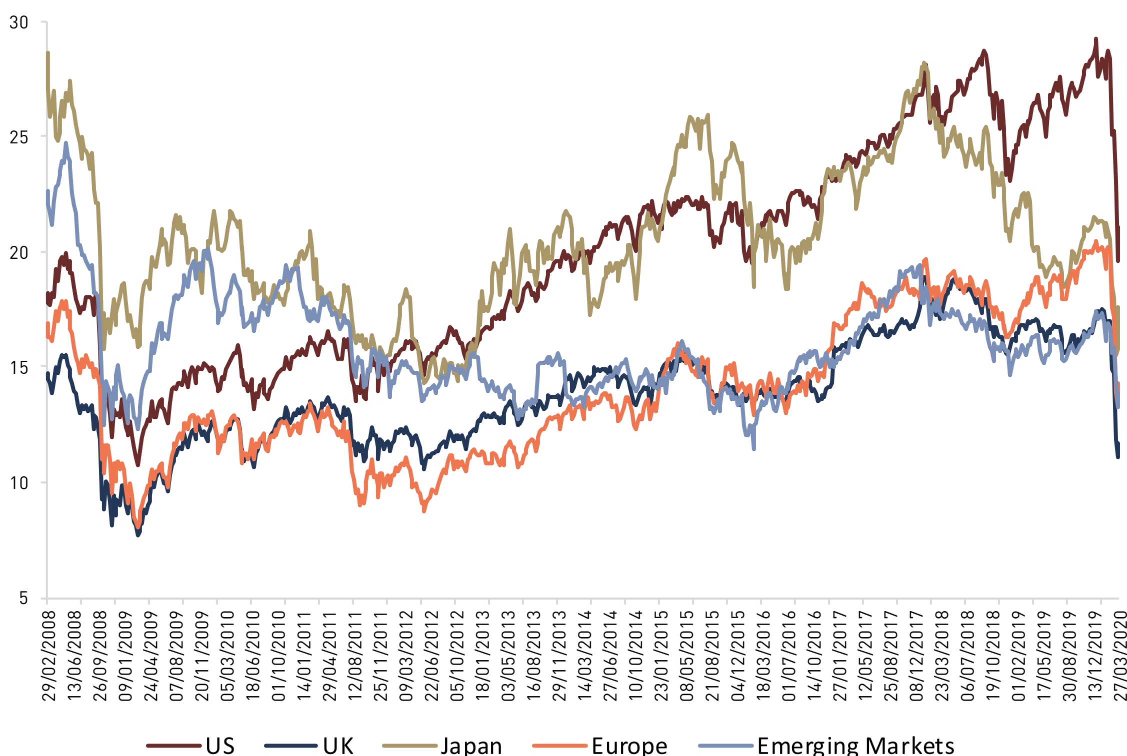
EQUITIES

Markets have re-rated considerably, but not yet to a level of being an obvious 'buy'

Analysing valuations of the equity markets seems somewhat churlish at a time when stock markets are experiencing day to day swings of 10%, and when at the time of writing we have only just moved away from record-high levels of volatility, and with such a large number of companies, big and small, ceasing to operate in any meaningful way at least temporarily.

Some businesses (such as in the retail, leisure and travel industries – particularly those with high debt levels) will clearly fall away in the coming weeks and months unless they are offered 'bridging loans' to the point at which they are allowed to start operating again and this means establishing fair value on an index that contains such companies is very difficult. Once the initial 'shock' period is over more rational buyers will return to the market, (like the pension funds) and then analysis will be more credible with a better idea of where the healthy companies are and which are set for continued growth. Until this point, it is a fact that equities as an asset class have re-rated to more palatable valuations than they ended 2019 at, and many represent a good buying opportunity for investors willing to accept some wobbling early on. All main indices P/E ratios have dropped below their 10 year average level, but actually few have dropped as low as they did in the 2008 financial crisis, suggesting there is scope for a further fall depending on virus news flow.

10 year P/E Valuations from 2008



Despite the sell-off, not many indices have got near their 2008 valuations yet...with a couple of exceptions. (source: Bloomberg)

We have identified some markets that are early contenders to be in pole position for strong recovery, however, which even at this point in time look to be worth considering. Both US small-caps (Russell 2000) and the UK FTSE 250 indexes are trading down at cyclically adjusted 2008 P/E levels, with the latter yielding an all-time high 6% dividend suggesting a very good historical purchasing opportunity. Indeed the UK market was relatively cheap pre-virus, and following a swift co-ordinated fiscal and monetary response by the government early investors could be rewarded here. The German DAX index has also re-rated substantially back to the financial crisis (a good a marker as any), and usually would be well-placed to participate in a global growth rebound, except that this time it may be that a realignment of global supply chains, specifically the German reliance on China may take some time holding stocks back, as nation states potentially reassess their dependence on far flung imports.

Lower valuations in Asia due to the proximity both geographically and economically, see us further drawn still to the region as an excellent source of long term growth and investment returns, and Asia represents a much greater proportion of global economic output than is reflected in most global equity or bond indices, but its clout in terms of both GDP and share of investment allocations will rise at a significantly higher pace than the global average. Clearly a period of lower oil prices will, over time, lead to a benefit for industry and consumers across the region especially for the net oil importer nations, though the higher Dollar adds funding strains at the same time – though we would expect this to unwind as the virus outbreak dwindles.

Finally, Asia at least for now appears to be closer to turning the corner in overcoming Covid-19, so logically could recover first, and with it growth, so we believe a selective and active approach to Asian stocks will be a key component of equity portfolios in the years to come.

After such a seismic shake-up of the equity markets we are confident that an active approach in general will reap rewards for stocks following what has been a boom period for passive strategies, as once the turbulence settles down, the various dislocations between asset prices and underlying valuations will become apparent. As stated earlier, short term sentiment will be dominated by virus headlines and statistics though we note on a technical basis the MSCI World chart has rebounded a little from its 10 year average level and a key resistance level (roughly in line with the market in 2015), and this gives us the confidence to contemplate cautiously adding to our equity position as we aim to move from an underweight to neutral position in the coming months.

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EQUITIES				■				**Virus sell-off is still in full swing, with high volatility making investing unnattractive. Selective buying opportunities are opening up for the long term.**
US			■	■				Valuations are re-rating rapidly. Value and small cap are lagging, though.
UK				■	■			UK stocks continue to underperform, but improving economic data and sentiment following election leads us to believe the catch-up story. BOE has been fast to react to virus.
Eurozone			■	■				Earnings and growth were slowing pre-virus, with Germany in particular stuggling with the stalling of global trade. French civil unrest dampens enthusiasm.
Switzerland				■				Quality, defensive nature of the market remains in demand, but we reduce our view to neutral following a stellar 2019. Held up better than most markets.
EM				■				We favour emerging Asia for the long term growth story with too much political risk elsewhere. Likely to emerge from virus before developed markets.
Japan				■	■			Attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Anaemic growth is countered by vast CB asset-buying which is underpinning market.

FIXED INCOME

Short-term corporate **default risk is high,** but central banks have moved swiftly and effectively

The overwhelming majority of the bond market has not escaped the widespread panic selling of financial assets as portfolio liquidations occurred across the board, with the Global Liquid Investment Grade index being down as much as 18% midway through March and only short-dated US Treasuries increased in price throughout. CLOs and US non-agency mortgage bonds, a darling of the market since the GFC, have suffered one of the steepest losses since 2008. AAA tranches have been retracing almost 8% and BB ones a whopping 38% in less than a month. As we have often acknowledged, government bonds at the near end of the curve will always provide refuge in times of crisis, but the yields are now so paltry (negative in many cases) that the case for holding them for any length of time is minimal. Rather like trying to time the bottom of the equity market perfectly, bonds have become so directional in nature that trying to exit a large position in Sovereign bonds before yields quickly revert is virtually impossible, and we would suggest that cash is a better temporary store of value. Corporate investment grade bond spreads globally do not offer sufficient yields to compensate holders for the risk of a deterioration in either earnings or a rise in default rates in our view, with the risk of corporate default over the next few months as high as it has ever been with many companies out of action altogether. Surely if it hadn't been

2 Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	05/25/2022	-0.821
GERMANY	03/11/2022	-0.728
FRANCE	02/25/2022	-0.684
NETHERLANDS	07/15/2021	-0.679
DENMARK	11/15/2022	-0.628
FINLAND	04/15/2021	-0.627
BELGIUM	09/28/2021	-0.613
AUSTRIA	09/20/2022	-0.571
IRELAND	03/15/2022	-0.554
SWEDEN	12/01/2020	-0.313
SPAIN	04/30/2022	-0.257
JAPAN	03/01/2022	-0.233

COUNTRY	MATURITY	YIELD + / -
PORTUGAL	10/17/2022	-0.219
UNITED KINGDOM	07/22/2022	0.103
ITALY	10/15/2021	0.176
AUSTRALIA	12/21/2021	0.201
NEW ZEALAND	05/15/2021	0.235
UNITED STATES	03/31/2022	0.263
ISRAEL	01/31/2022	0.340
HONG KONG	02/21/2022	0.518
CANADA	05/01/2022	0.554
SINGAPORE	10/01/2021	0.711
ICELAND	08/05/2021	1.910

(source: Bloomberg)

for the promise of stimulus and the near-unilateral emergency slashing of interest rates, the bond market would have fallen further still.

The High Yield market has been hit especially hard, struck by the dual headwind of the virus shutdown and the collapse of the oil price, with a large component of the US high yield market being oil and gas companies – speculative bonds are now yielding over 10%, and there are undoubtedly some bargains to be had in the form of perfectly healthy businesses.

For now the contagion is dragging the whole market down, seemingly exacerbated by the sheer amount of bonds held in ETF's and huge active funds that limit the ability of safe bonds to differentiate themselves from troubled ones. The crisis has seen a very strong US Dollar and this has held back emerging market bonds, despite many EM countries remaining relatively unscathed by the virus – emerging market debt, especially Asian, could see spreads tighten should the dollar retreat later in the year and like stocks could get a boost from cheaper oil. Through the turmoil, duration concerns have been somewhat lost as investors flee to cash and short-dated Treasuries, with the dramatic emergency rate cuts by central banks across the world almost being lost amongst the headline stimulus figures. Interest rates are at all-time lows and look to stay rooted there for the foreseeable future as policy makers look to soften the blow of the virus, and ordinarily we would be looking to increase the duration of our fixed income basket, however the yield curve has steepened to such an extent that the carry on offer negates the need to take too much duration risk, so we maintain a neutral stance. We will look to add corporate debt exposure, once we see yields at attractive levels and the current uncertainty over default rates passes.

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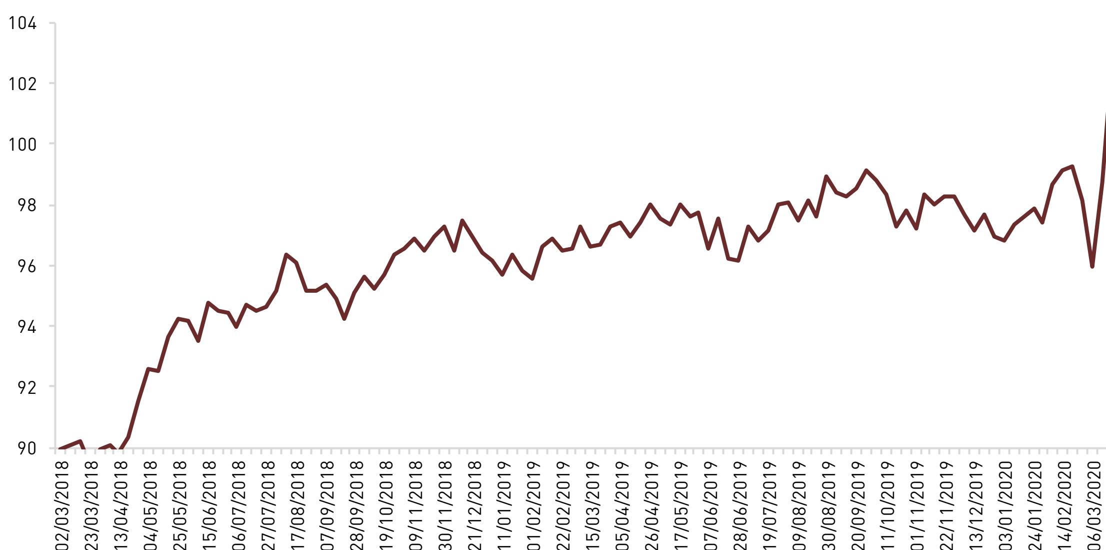
FIXED INCOME				**Low yields and low return profile make bonds a relatively unnattractive asset class, though Treasuries remain a short term safe haven.**
Sovereign Bonds				Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Corporate I.Grade Bonds				Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
High Yield Bonds				Oil shock plus virus economic concerns have hammered the market, selective opportunities thus exist.
EM Bonds				Yields are still relatively preferable to developed markets, though we only choose to take low-duration, quality exposure. Trade war risks. Hard currency for now.

COMMODITIES AND CURRENCIES

Dollar strength will be a key factor within a wider recovery

At the start of the year the markets were spooked by the supply shock of the attack on the Saudi refinery but then as the virus outbreak began to take off in Europe markets were further unsettled by the culmination of the tension between Saudi Arabia and Russia over the production of crude oil, with the Saudi's deciding to flood the market with cheap oil in a shameless attempt grab market share at a time when demand had started to tail off. The result of this was to half the price of crude, while jeopardising the economies of oil-producing nations around the world. With the lowest cost of extraction being in Saudi Arabia, the Kingdom's actions could mark the end of OPEC , in addition to the falling-out with Russia, as other members grapple with the loss of income as oil lingers at around $25 a barrel. We would expect this to rise back to trade in between the $30-40 levels, as it moves off its lows but remains under pressure from a supply and demand shock, and this ironically could prove a lifeline to the many embattled transport and freight companies as well as assisting the commodity-importing economies to get back on their feet. Running alongside the tumbling oil price has been the strengthening of the US Dollar, which has once again spiked due to its reserve currency status and cash liquidity that everyone wants when panic sets in, at

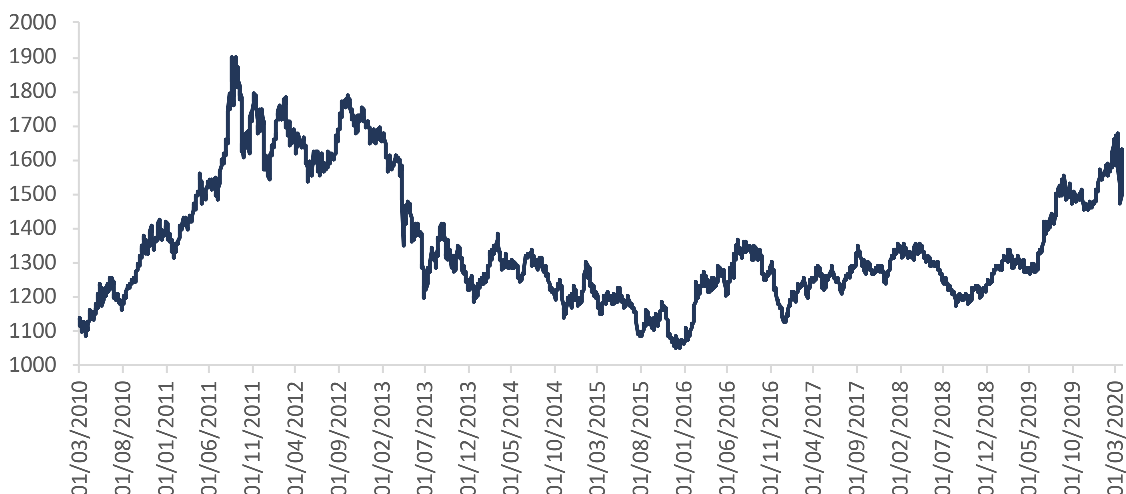
US Dollar (DXY Index)



The Dollar as measured against a basked of other currencies has surged during the Coronavirus crisis, as investors turn to cash and the ultimate form of liquidity. (source: Bloomberg)

a time when interest rates everywhere are around zero meaning there is no FX carry to speak of. The demand for Dollars will no doubt continue as long as the Coronavirus continues, underpinning it in the short-term and the state of its major FX crosses effectively mean a default to dollars as EUR, JPY and GBP are restricted by their own increasingly loose monetary policies. Another familiar theme that has resurfaced due to Coronavirus is the structural flaws of the Euro, with predictable questioning of the single currencies long term viability in the face of the varying needs and interests of the Eurozones' nations and economies – magnified by the fact that Italy is being hit the hardest by the disease. Italy simply cannot afford to 'spend their way' out of the crisis, with it's GDP still 5% below 2008 levels and is heading towards the 150% debt/GDP ratio which is unchartered territory for a member of a currency union, and neither really can Spain, Portugal or Greece and Cyprus. The ECB and EU will be keen to avoid imposing further debt on these countries at such a time, but equally the wealthier nations will not take kindly to effective cash handouts and this could put great strain on the Euro, whatever the political will (which actually has been very strong historically). It is therefore not difficult to see why the Dollar remains elevated, even though this is actually anathema to a swift global recovery. Finally, gold, which strengthened at the initial start of the crisis, disappointed many by capitulating with every other asset class in the midst of the panic liquidating, though to expect it to act in perfect negative correlation to stocks is to misunderstand its purpose in an investment portfolio, and the conditions now are well set for a decent run for precious metals: interest rates everywhere are near zero or below, government spending has just moved up a (large) notch and there will remain residual fear in the markets for some time. Gold is currently in strong positive territory year to date with most other asset classes nursing double-digit percentage losses and we believe it has further to go.

Gold - the last 10 years



The precious metal has been rising steadily for 4 years and looks set move higher in the context of extreme monetary easing, zero interest rates and fear. (source: Bloomberg)

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ALTERNATIVES								**Uncorrelated assets will play an increasingly important part of a portfolios' asset allocation.**
Precious Metal								Gold is supported long term by low yields in fixed income and loose monetary policy. Safe haven reputation has taken a hit due to mass margin call liquidations.
Hedge Funds								Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation.
Oil/Commods								Saudi's have removed floor from market and possibly broken Opec. Over supply, plus virus-led demand shock lead to bearish case.

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CURRENCIES								**Asset market volatility dominates sentiment. The Coronavirus implication for other asset classes initially lead to little directional movement of the major currencies. However post the initial asset liquidation cycle currency divergence has now occurred. Liquidity has drastically reduced and safe liquid havens have been sought.**
US Dollar (DXY)								The US Dollar is currently viewed as the safe liquidity home. DXY index has moved to the top of the past five year range at 102, rallying from 99 in the past couple of weeks.
Sterling (GBP)								DXY strength and UK virus concerns has led to a sharp decline in Sterling. Against the EUR, Sterling trades at the post '2016 Brexit Election' lows and at the lowest level against the Dollar in over thirty five years.
Euro (EUR)								Eurozone growth has slowed and monetary policy is loose. Expect medium term weakness as Brexit/trade risk remains.
Japanese Yen (JPY)								Converging global interest rates has removed the JPY's safe haven status – leaving it, although volatile, to tread water against the US Dollar and EURO.
Swiss Franc (CHF)								The CHF has marginally outperformed other European currencies in the past month - gaining 1% against the EURO. We would highlight this as perceived safe haven harbour on the continent.

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The availability of the services described in this brochure may be restricted by law. Further details are available upon request.

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