Investment Views

April 2020

It seems vaguely churlish to focus on the narrow field of investment as the world struggles to understand and control this unfolding pandemic. We thus offer the following thoughts with the humble acknowledgement that many are focused on more worthwhile and urgent matters at this time. To those that are in the front line of the global response, we offer our thanks and support. To you, our clients and friends, we hope you are surrounded and supported by family and friends, as the uncertainty of this challenge plays out.

At the end of last year, the world was highly indebted. As oft noted in these pages, we solved the 2008/09 debt crisis with more debt. By late 2019, Governments of the advanced economies had accumulated gross debt-to-GDP of 104%, up from 71% in 2007. For emerging nations and developing economies indebtedness rose from 36% to 53% over the same period (source: IMF). Lest we damn our profligate politicians, companies have also been gearing up. The non-financial sector in advanced economies saw debt-to-GDP rise 30%, to 271%; emerging market peers added nearly 60% to 188% (source: the BIS).

Setting aside the sad human costs of this pandemic, Cov19 is the ultimate test for such indebted balance sheets. With nearly 3.5bn people subject to some form of lockdown (c. 45% of the world's population), the global economy has hit pause. Aggregate demand has collapsed; supply chains are broken. US initial jobless claims rose by 10m in the last fortnight; France added 4m. Whether the second quarter sees an annualised contraction in global GDP of 10%, 20% or 30% is irrelevant; the near term hit to economic activity is unprecedented outside times of war.

This precipitous shutdown has catalysed many of the fragilities we have obsessed about for the last 2 to 3 years. The most obvious casualty has been credit markets. Corporate bonds and asset-backed securities have sold off sharply. The extra yield (or spread) that one gets on a 10 year BBB-rated $ corporate bond, versus the equivalent US treasury, has doubled to 3% this year. For lesser quality, high yield $ debt the spread has widened from 3% to 9%. This latter category has been aggravated by the plunge in the oil price, with the spread on high yield energy debt blowing out to 21%; a 14% rise. The price of WTI crude oil has plunged from $60/barrel to $20, as Saudi Arabia floods the market with supply. Faced with a slump in oil demand, they are trying to force Russia and the US shale producers to cut production. In the energy space and elsewhere, default rates are set to rise sharply as borrowers struggle to meet existing obligations and are crippled by sharply higher rates when they come to roll their debts.

The pain is not limited to the corporate sector. Tracker funds that follow emerging market government bonds have seen 19% (local currency) and 26% ($ denominated) falls, peak-to-trough, whilst the iShares US municipal bond ETF shed 34% intra-month before clawing back some of the losses. Solvency concerns abound.

These rapid moves have been amplified by another well-flagged vulnerability; market liquidity. After the financial crisis, investment banks were restricted from trading their own capital. This has reduced their ability to facilitate equity and bond trades, as they have limited capacity to take client trades onto their books before selling them on. This severely impairs liquidity at times of market stress, increasing volatility and price spreads. With many highly leveraged investors, especially funds driven by algorithms, forced to sell as markets fractured, the pace and magnitude of market moves rose dramatically. This spike in volatility became self-feeding as it triggered more selling and risk reduction. After such violent price swings, there will be some very high profile casualties, as various hedge funds finally admit their losses.

So what next? The monetary and fiscal response has been breath taking. Whilst all the central banks have redoubled their QE efforts, the US Federal Reserve has been the most aggressive. Having cut base rates to 0-0.25%, it ramped up its bond buying program, extending eligible securities from US government debt to corporate bonds and various types of asset backed security. In an open ended commitment, it will buy unlimited amounts of bonds “in amounts needed to support smooth market functioning and effective transmission of monetary policy”. Whilst the actions seek to cap rates and provide liquidity to bond markets, the Fed is now openly financing the US Government. It is creating new dollars to buy treasuries, thereby financing government expenditure. Whilst this may seem like a necessary evil at this time, a rubicon has been crossed. Monetary and fiscal policy are being merged, leaving the dollar vulnerable to political overlords. If you include Trump’s $2trn support package, the combined fiscal and monetary stimulus could easily touch 30% of US GDP. Similar initiatives, both in scale and scope, have been launched across the globe.

Further out, after the peak-virus period, these programs will have far reaching consequences. Many of the emergency policies will outlive the crisis. In particular, as politicians try to reinvigorate over-indebted post-pandemic economies, will they be able to resist printing money to finance their efforts? How will inflation react? We will revisit such matters in future editions.

More immediately, will these policies protect the global economy, ensuring that the disruption to activity is short and sharp but ultimately transient; a so-called “V” shaped recovery? Sadly, we fear not.

As regards the monetary stimulus, this will have little impact on economic activity; money was already cheap and plentiful for those with access. The steps taken by central banks, the Fed in particular, have secured the “plumbing” of the financial system. Concerns over liquidity and orderly markets have been allayed and vast swap lines have channelled dollars from the US to other countries. The latter is a major issue, as many non-US companies (and countries) have significant dollar debts to service.

As regards the fiscal response, whilst the scale is impressive, current government initiatives are struggling to deliver funds to those in need in a timely fashion. In the UK, EU and US the various initiatives will take several more weeks to deliver; too slow for companies that are laying off workers and going bust now. As this becomes increasingly apparent, a more urgent policy response is probable, directly placing cash in consumer's hands; akin to the HK$10,000 gift for HK residents announced in late February.

In the west, the virus and the economic disruption have yet to peak. The longer they drag on, the more permanent the economic damage and the slower the subsequent recovery. Quarantine measures look set to endure into the early summer, with the US playing backmarker. Thereafter, using China as a guide, the path to 100% activity is gradual and nervous as authorities balance the desire to reengage with the fear of a resurgent virus.

Where does that leave equity markets? Intra-month the S&P500 lost 34% with UK, EU and Japanese indices falling back 30-40%. China proved a relative safe haven, ending the quarter 15% lower. With stocks rallying by nearly 20% into the month end, is the bear market over? Again, we fear not.

At the time of writing consensus estimates for S&P500 earnings show a 10% decline in the second quarter, a 1.1% contraction in the third and 4.5% growth in the final quarter. Overall, they expect 2020 earnings to fall 1.2%, year-on-year (source: Factset). This is ludicrous and stretches even the most bullish credulity, especially as every CEO has an incentive to "kitchen sink" bad news during this unusual time.

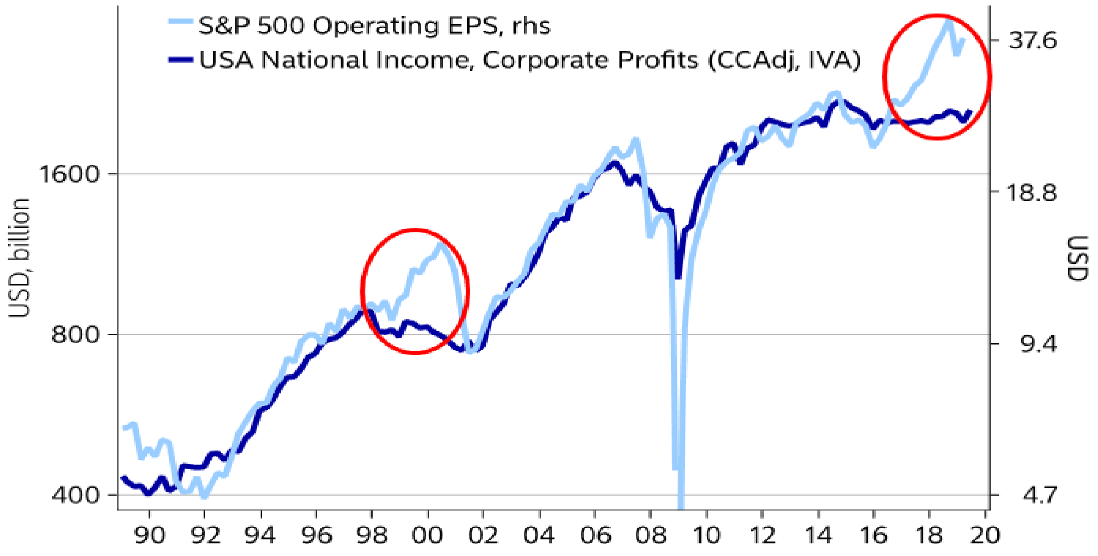
Looking at it a different way, the S&P500 earned $163 in 2019. If we simply write off 2020 as "bad but unknowable", let's assume that earnings bounce back in 2021, recapturing their 2019 peak; a fairly generous assumption in our view. If that occurs, the S&P500 stands at a 15.9 times forward P/E (price/earnings ratio); not a million miles away from its 10-year average of 15x. However, during troubled times, risk averse investors tend to attach less generous multiples to their best guess at future earnings. If we attach an 11x multiple, last seen at the 2009 nadir, that gives us an S&P index level of c. 1800. That is 30% below the end March index level and nearly 50% below the February peak.

Given that the dotcom bust and the financial crisis saw the US market lose 49% and 57% respectively, a range of 1,800 to 2,000 on the S&P500 seems a reasonable baseline. This is not a target. However, having avoided the worst of these market falls, it provides a dispassionate level, to test our conviction, as we consider what (and when) to buy.

In addition to dividends, companies often use available cash to buy back some of their shares on the open market. Proponents argue that this boosts the return on equity and reduces the number of shares in issue, thereby increasing the profit (or earnings) per share (EPS). Executive compensation is often linked to EPS growth.

Unfortunately, companies used free money for the sole purpose of buying back shares. Whilst this enhances EPS (a key driver of stock prices), it does nothing to enhance future profit growth; the resulting leverage also leaves the company exposed to any slowdown in their revenues and/or a rise in the cost of the borrowed funds.

The chart below shows EPS for the S&P500 (light blue line) and the total value of corporate profits from the national income accounts (dark blue line); at moments of peak euphoria, the two tend to diverge. EPS are inflated by “one off items” and by aggressive share buybacks. The same earnings divided by a lower share count boosts earnings per share.



Source: Macrobond and Nordea

Why does this matter? Well, in the last decade corporations, especially in the US, have aggressively borrowed to feed buyback programs. As noted in the lead article, this has left them heavily indebted and defenceless in the current stressed environment. To illustrate the point, over the last 5 years some of the largest US airlines (Delta, American, United, Southwest and Alaska) have spent $44.9bn or 96% of their free cash flow on share buybacks and dividends. They have also paid out nearly $750m to executives. Having geared up to pay these sums, they are now part of an industry asking for a $50bn bailout from the US government (source: Bloomberg).

Whilst there will surely be push back against such behaviour in the future, we also note that total US profits have basically stalled since 2014. We note that the S&P500 traded between 1800 to 2000 that year, reinforcing our thoughts about the equity market baseline.

Dividends & Banks

In the final days of March, regulators in the UK and Europe guided their domestic banks to suspend all plans to return money to shareholders, including outstanding dividends from last year. Executive bonuses also came under the knife in an effort to preserve capital. Further afield, with the Government being asked to prop up a wide array of industries, shareholder pay outs are under threat; many household names have followed the banks, including M&S, Ford and ITV.

For the banking sector this seems prudent, but we suspect there is a wider agenda. The Euro Stoxx index of EU banks ended the first quarter at a new low, some 90% below its 2007 peak; many European banks never fully recovered from the financial crisis.

By forcing all banks to preserve capital, regulators de-risk this important sector and ensure that they have sufficient capital to support the emergency fiscal measures; banks are being encouraged to lend to distressed borrowers throughout this crisis. As importantly, by forcing <u>all</u> banks to eliminate pay outs, it removes the potential stigma attached to such steps. If only a few cut their dividend, it would highlight their weakness and risk a severe market reaction and panic amongst depositors/clients.

The latter point has echoes of the US banks during the financial crisis, when the authorities forced all of them to accept support, even if they did not need it. Singling out individual banks for emergency aid would have been the death knell for such trust-based institutions.

As regards Governments using the banks as policy tools, this is a truly significant development; one of many rubicons that are being crossed that would have been unthinkable only a few months ago. If a quoted company can be forced to implement local Government policy and to incur losses as a result, it is no longer an independent entity in the traditional, capitalist sense. It is on the road to being a quasi-nationalised utility.

As such, there is a very good chance that banks revert to being what they were before Reagan, Thatcher and the post-1980s explosion of financial engineering. They will become less exotic, forsake their riskier endeavours and revert to being dull high yield stocks alongside waste, water and electricity companies.

Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Latin America Gold Miners China A Shares UK mid-caps	Inflation Linked Emerging Market	Uncorrelated Strategies Gold
–	Equities Bonds	European US Technology	UK European Japanese Corporate High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 March 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2420	-3.1%	-6.3%	-4.7%
CHF	1.0404	0.4%	0.7%	3.6%
AUD	0.6131	-5.9%	-12.7%	-13.6%
JPY	107.5400	-0.3%	-1.0%	-3.0%
EUR	1.1031	0.0%	-1.6%	-1.7%
BOND YIELDS (10 yr)				
UK	0.35	-0.09	-0.46	-0.64
US	0.67	-0.48	-1.25	-1.74
Germany	-0.47	0.14	-0.29	-0.40
Australia	0.76	-0.05	-0.61	-1.01
Japan	0.01	0.17	0.03	0.10
EQUITIES				
US. S&P 500 (USD)	2,584.59	-12.5%	-20.0%	-8.8%
UK. FTSE 100 (GBP)	5,671.96	-13.8%	-24.8%	-22.1%
FTSE Europe Ex UK (local)	225.25	-14.5%	-21.9%	-13.3%
Japan. Topix (JPY)	1,403.04	-7.1%	-18.5%	-11.8%
China. Shanghai Comp (RMB)	2,750.30	-4.5%	-9.8%	-11.0%
HK. Hang Seng (HKD)	23,603.48	-9.7%	-16.3%	-18.8%
Australia. All Ords (AUD)	5,110.56	-21.5%	-24.9%	-18.4%
FTSE Asia Pac ex Japan	445.72	-14.7%	-21.6%	-18.1%
FTSE World (USD)	518.11	-13.8%	-22.0%	-12.8%
FTSE World (GBP)	619.50	-11.2%	-16.7%	-8.4%
COMMODITIES				
Oil (WTI)	20.48	-54.4%	-65.8%	-65.3%
Gold	1577.18	-0.5%	3.9%	22.0%

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