Investment Views

May 2020

The economic data is dire. In the US, first quarter GDP shrank by 4.8%, with far worse to come. Oxford Economics expects a peak-to-trough contraction of 12%, three times worse than the financial crisis. Over 30m Americans have filed initial jobless claims in the last 6 weeks; if they all register as unemployed, the jobless rate will head north of 20%. To set that in context, 2008/09 saw a 10% peak. The picture elsewhere is equally bleak, with Europe being hit even harder. Given the lack of coordinated response from member states, local banks look vulnerable and we expect European unity to be (re)tested as lockdown losses challenge the more indebted nations. European politics will become increasingly toxic.

As expected, company profits have collapsed. At the end of March, we questioned S&P500 earnings growth forecasts of -10% in Q2, -1.1% in Q3 and +4.5% in the final quarter. These Panglossian predictions have now slumped to -37%, -20% and -9%. The risk remains to the downside as companies pull earnings guidance at records rates.

Buoyed by an endless flow of cheap money, stock markets have dismissed the data as yesterday's news, rallying hard from their late March lows. The equity bulls continue to expect a relatively rapid return to normality borne of unprecedented State intervention. The S&P500 ended April up 30% from its nadir; its best month since 1987. Even though the global rally fell short, the FTSE World ex-US still managed to rise 22% over the same period.

Despite FOMO (fear of missing out) infecting many, we retain our bearish demeanour and have been trimming equity holdings into this rally. We expect the economic drag of Cov19 to continue longer than the hopeful predict. Until a vaccine has been discovered, tested, produced and distributed to billions, countries will toggle between lockdown and varying states of sub-par activity. Bill Gates, who seems to offer the best informed and least conflicted views, estimates a vaccine could be available within 9 months, whilst cautioning that it might take 18 to 24 months. The start-to-finish process of delivering a new vaccine usually takes c. 5 years (see gatesnotes.com). Importantly, even the fastest predictions see the western world entering the autumn flu season without a vaccine, increasing the risk of virulent subsequent waves. Over the coming months, estimates of the "R0" rate of infection will dictate how politicians balance the desire to limit Cov19 deaths with the need to fire up recessionary economies. We do not envy them the task; a perfect outcome is simply "less bad" than the alternatives. Social unrest will surely rise as the uncertainty drags on.

Whilst no one knows how deep and protracted the economic fallout will be, with the S&P500 trading at over 20 times forward earnings, this can only be justified by the heroic assumption that we return to 2019 levels of activity and profitability by the first half of 2021. We beg to differ.

Our growing conviction is that the abrupt pause in global activity has amplified a disinflationary wave that pre-existed Cov19. Aggregate demand has contracted faster than aggregate supply, as a highly leveraged global economy has been derailed by an end of cycle shock.

Again, referencing the US to illustrate, household consumption (which accounts for nearly two thirds of economic activity) fell 7.5% in March, the sharpest monthly decline since records began in 1959. Conversely, the personal savings rate has risen to 13.1% of disposable income; a three decade high. As companies and individuals emerge from the most extreme forms of lockdown, there will likely be an uptick in delayed spending on necessities. However, elevated unemployment will cap discretionary spending and uncertainty will encourage companies to postpone capital investment and (re)hiring. Ongoing restrictions and social distancing will also deny a profitable level of activity to large swathes of the economy; restaurants and airlines lose money if they are forced to operate at 30% capacity.

Ironically, the initial response from Central Banks has amplified the problem. In the near term, by propping up flawed businesses with cheap loans and furlough schemes, the authorities are sustaining 'zombie' companies. Even before the virus appeared, cashflow failed to cover debt interest costs at 16% of US companies (source: Morgan Stanley). A growing army of 'zombies' generate excess supply putting downward pressure on prices and margins.

The emergency Cov19 loans could also leave individuals and companies focused on reducing leverage rather than expanding their activities as restrictions lift; a further drag on any demand recovery.

Looking further out, this deflationary narrative risks birthing a far more inflationary chapter. As growth stalls and general price growth sinks below 2% targets, the Authorities will be encouraged to double down on both monetary and fiscal stimuli. Indeed, the lack of inflation will give voice to those that advocate modern monetary theory (MMT); a set of policies that effectively funnels freshly printed money from Central Banks to Government and consumers. Whilst a negative output gap exists, with aggregate demand below aggregate supply, the inflation risk is modest. However, supply will eventually shrink to meet the level of demand in the economy. Cheap money can keep 'zombie' companies alive for a while but it will not make a bad loan good; eventually debts will be overwhelmed by a prolonged collapse in revenues. Insolvencies will rise.

Companies also face a less productive future. Informed by the current fragilities, global supply chains will become less efficient as production moves closer to home and companies diversify suppliers. They will also hold more precautionary cash on their balance sheets and reduce gearing. Businesses will be pressured to focus on a wider set of stakeholders, rather than shareholders alone. The temporary 13% increase in pay for Amazon workers will surely endure, as pressure builds to increase the pay and benefits of the least well off. Again, margins and productive capacity will suffer.

Finally, the political environment will become less supportive as indebted Governments, under pressure to raise social spending, increase taxes on income, wealth and corporates.

As aggregate supply shrinks and the output gap narrows, the risk is that renewed stimulus/MMT creates excess demand and inflation (or the fear thereof). This becomes even more likely if Governments agree to some form of debt forgiveness. It seems possible, indeed likely, that student debt and elements of emergency loans will be written off. This would be a rapid and highly effective way to stimulate aggregate demand, as it would disproportionately increase the purchasing power of young people; under-35's have the highest marginal rate to consume. It would also prove politically popular as we head into a November US election.

Taken in the round, over-valued equity markets remain vulnerable as the prolonged impact of this virus shows up in corporate and economic data. The flood of liquidity may support equity markets in the near term, but we expect them to recouple with fundamentals as this pandemic drags on; we recognise that the latter phase could take months to unfold, rather than weeks. When markets slide and inflation falls, the Authorities will deploy increasingly desperate policies in an attempt to stimulate growth and to head off a debt-deflation spiral. Will that trigger a bout of inflation? Will we see 1970s stagflation? We do not know. But we strongly suspect that there will be a period where these worries are front and fore.

Lockdown Lingo

Since the lockdown, cabin fever has unleashed an endless stream of jokes and video clips on social media. Whilst the quality and humour can, at times, be dubious we share some extracts from 'lockdown lingo'; a list of new words and phrases that arrived via one of our many WhatsApp groups.

Quarantinis - Experimental cocktails mixed from whatever random ingredients you have left in the house. A Blue Curacao and Ribena quarantini with a glacé cherry garnish, anyone? These are sipped at "locktail hour" which seems to be creeping earlier with every passing week.

Le Creuset wrist - An aching arm after taking one's best saucepan outside to bang during the weekly 'Clap For Carers.' It might be heavy but you're keen to impress the neighbours with your high-quality kitchenware.

The elephant in the Zoom - The glaring issue during a videoconferencing call that nobody feels able to mention. e.g. one participant has dramatically put on weight, suddenly sprouted terrible facial hair or has a worryingly messy house visible in the background.

Goutbreak - The sudden fear that you've consumed so much wine, cheese, home-made cake and Easter chocolate that your ankles are swelling up like medieval Royalty.

Covid-10 - The 10lbs in weight that we're all gaining from comfort-eating and comfort-drinking. Also known as "fattening the curve".

The S&P500 lost 34% from its 19th February peak to the March 23rd low. It has since recovered to end April down 12% for the year to date. Although the headline index has rallied sharply, the breadth of this move has been narrow; most stocks fell, but only a few have recovered. If you look at the S&P600 (small cap) index, it remains 27% down this year, whilst the equal weighted S&P500 index is 19% lower. The latter has the same constituents as the S&P500 but they are weighted equally, not by market capitalisation, thereby removing the dominant influence of a few large stocks.

The US index is increasingly concentrated into a handful of mega cap names. Microsoft, Amazon, Apple, Facebook and Alphabet/Google together account for 20% of the index and 23% of the recent market recovery. The index is now more concentrated than the dotcom peak.

Looking at it another way, starting in September 2018, the chart below shows the S&P500 (blue line/left hand axis) versus the % of US stocks that are trading above their 200 day moving average (the white line/right hand axis). Put simply, if a stock is trading above its 200 MAV, it has positive price momentum. A healthy broad based rally will see most stocks with positive price momentum; typically, 60-70%.

If you look at the Q4 2018 market fall on the left of the chart, you can see that as the market fell (20%), the price momentum sank; the white line bottomed at c. 10%. It then recovered quickly, validating the bounce in the S&P500. You will note that during the recent market rally the white line has barely moved; at 15%, it is still very close to the bear market low.

Unless this rally widens out, it will be vulnerable to any bad news from one or more of the dominant players. It was thus interesting to see Amazon and Apple issue cautious trading updates on their first quarter earnings calls. These are amazing businesses that will continue to transform the commercial landscape, but they are priced for perfection in hugely uncertain times.

On the flip side, the US energy sector has achieved pariah status; the whole sector now accounts for 3% of the index, 1% less than Amazon. With oil trading at historic lows (and even going negative briefly last month), our research suggests that large integrated oil companies offer value, both as recovery plays and for their yield. They also have attraction if inflation fears return.

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	Gold Miners China A Shares UK mid-caps Sustainable yield	Inflation-linked, Emerging Market	Uncorrelated Strategies, Gold
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

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

	30 Apr 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2594	1.4%	-4.6%	-3.4%
CHF	1.0356	-0.5%	-0.2%	5.6%
AUD	0.6512	6.2%	-2.7%	-7.6%
JPY	107.1800	-0.3%	-1.1%	-3.8%
EUR	1.0955	-0.7%	-1.2%	-2.3%
BOND YIELDS (10 yr)				
UK	0.23	-0.12	-0.29	-0.95
US	0.64	-0.03	-0.87	-1.86
Germany	-0.59	-0.12	-0.15	-0.60
Australia	0.89	0.13	-0.06	-0.90
Japan	-0.04	-0.05	0.03	0.01
EQUITIES				
US. S&P 500 (USD)	2,912.43	12.7%	-9.7%	-1.1%
UK. FTSE 100 (GBP)	5,901.21	4.0%	-19.0%	-20.4%
FTSE Europe Ex UK (local)	239.17	6.2%	-16.4%	-11.1%
Japan. Topix (JPY)	1,464.03	4.3%	-13.1%	-9.5%
China. Shanghai Comp (RMB)	2,860.08	4.0%	-3.9%	-7.1%
HK. Hang Seng (HKD)	24,643.59	4.4%	-6.3%	-17.0%
Australia. All Ords (AUD)	5,597.65	9.5%	-21.4%	-12.8%
FTSE Asia Pac ex Japan	490.04	9.9%	-10.4%	-11.4%
FTSE World (USD)	573.39	10.7%	-12.8%	-6.6%
FTSE World (GBP)	673.95	8.8%	-8.9%	-3.4%
COMMODITIES				
Oil (WTI)	18.84	-23.1%	-63.6%	-69.1%
Gold	1686.50	6.9%	6.1%	31.4%

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