Investment Views

June 2020

Back in February, as the S&P500 peaked at 3,394, analysts were expecting 5% earnings growth for the year. Then COVID19 went global and economies stalled as pandemic fears triggered urgent lockdowns. In the US, the Atlanta Federal Reserve GDP model is predicting a 53% second quarter contraction leading to a sharp revision of earnings forecasts; 2020 is now expected to see a 20% decline (source: Factset). Whilst that's an abrupt volte face, the dotcom crash and the financial crisis saw earnings tumble 54% and 92% respectively.

The US stock market has remained remarkably sanguine. Having fallen by a third, it has recovered from a March 23rd nadir to end May within 10% of the prior high. If the lows are in for this bear market, it will be the shortest ever and shallower than the last three.

To sustain this market move one has to believe that Central Banks will keep rates at or near zero for several more years. You also have to believe that the record fiscal support (loans, furlough payments, stimulus cheques et al) have protected the productive capacity of major nations, enabling a rapid reacceleration of growth as lockdown restrictions lift. Finally, one must put faith in the idea that we will be able to effectively treat or vaccinate against COVID19 before a second wave of the virus arrives (or that there is no virus recurrence).

Even then, the optimists anticipate a listless world where economies recover and then drift; weighed down by vast debts, trend growth and inflation in developed nations hover around 1% pa. Bond yields, residing near zero, remain anchored encouraging (forcing?) investors to bid growth equities to record valuations. TINA (there is no alternative) takes another turn.

This is possible but not probable. Whilst the West and most of Asia have seen the worst of 'Wave 1' (both medically and economically), they are not emerging unscathed. The dramatic break in activity has exposed the systemically challenged. Front and centre is the accelerated decline of 'bricks & mortar' retail as shopping moves online. It has also exposed the cyclically frail; a large number of companies that entered this downturn with too much debt. Crisis support can prop these zombies up for a while but solvency will collapse (and defaults rise) as time passes and reserves are exhausted. By mid-April, $150bn of US corporate debt had been downgraded from investment grade to 'junk';

the so-called 'fallen angels' including Ford, Macy's, numerous airlines and shale oil producers. That exceeds 2009 and continues to rise apace, with private equity backed companies dominating the lower rungs of the corporate debt ladder. Fighting for survival, these troubled companies will not hire and invest; the cornerstones of any vibrant recovery.

The ripple effects are spreading far and wide, with property an obvious casualty. Various surveys in the UK and US indicate that up to half of residential and commercial tenants are either late in paying or have refused to meet their rental obligations in April and May. The end June rent cycle will give a clear steer on how pervasive and sustained the problems are. Landlords and the related debts are exposed as demand for shops, offices and restaurants slumps.

Turning to employment, 40m Americans have now filed for unemployment benefits since early March, with the April jobless rate touching 15%. It was 3.5% at the turn of the year. Further afield, 19% of UK workers are now furloughed with the Government paying 80% of their salary and employment cost. In Germany the figure is 23%, rising to 41% in France. These schemes are cripplingly expensive, with the UK job support initiative slated to cost £100bn by the time it ends on 31st October.

Of course, many of those affected will gradually return to work as activity builds; but many will not. At this time, the split between hired and fired is unknowable, but a return to 2019 rates of employment is fanciful.

Pulling all this together, we see a bounce in activity as lockdowns lift and delayed orders are filled; stock markets will continue to cheer and extrapolate this initial improvement. Thereafter, the recovery will slow as unemployment settles at a higher plateau and companies wrestle with additional debt and softer demand. Faced with this fragile economic reality, Governments will struggle to remove the emergency fiscal props. In the same way that companies became dependent on artificially low rates, making temporary QE permanent, a growing cohort of businesses cannot survive without furlough schemes and soft loans. With their reserves gone, any withdrawal of support risks a second round of redundancies and a deeper recession. Given the concentration of economic pain amongst the least well-off, will politicians endure the blowback from less fiscal assistance, especially when their Central Banks seem willing and able to finance the policies? We doubt it. Under such a scenario, it seems increasingly likely that equity markets will be forced to reconnect with real world fundamentals, including the grumbling uncertainty of Sino/American relations and the November US Presidential race.

All of the above assumes that there is no meaningful second wave or that there is a widely available medical solution before one arrives. Given that the world has never developed a successful coronavirus vaccine, including for the likes of HIV, it seems reasonable to assume that a COVID19 inoculation is some way off. If that is the case, a second wave could push both economies and markets to retest recent lows. Governments would be less likely to initiate strict lockdowns, worried about the impact on struggling economies. Citizens would be less likely to obey, emboldened by low infection rates in 'Wave 1' and a desperate need to hold onto their jobs. Frustration is already evident in the riots sweeping across America. Nations will need to decide on the balance between economic necessity and citizen mortality; sadly, the debate will be chaired by political incumbents who have been found sadly lacking.

Free Money?

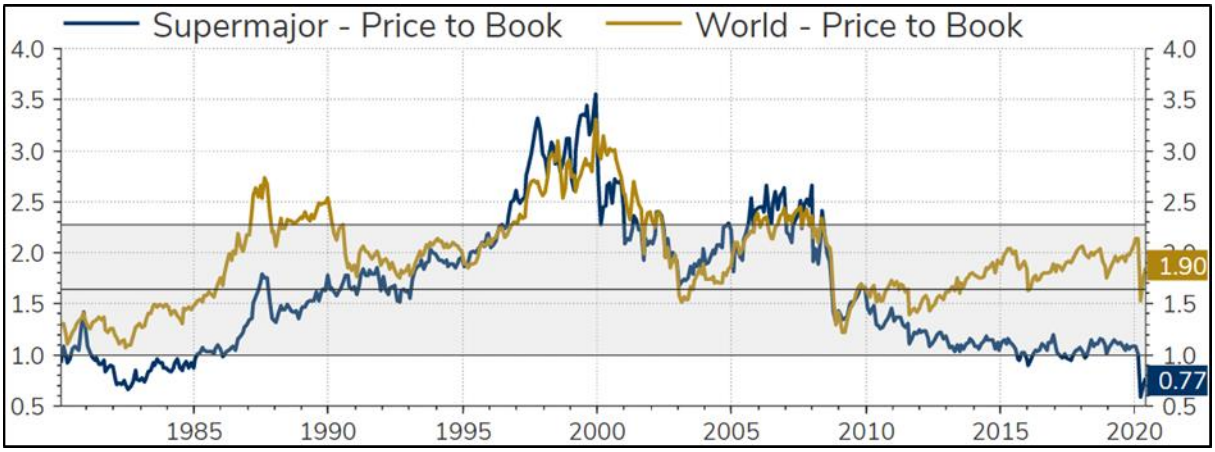
As part of US Government efforts to prop up aggregate demand, the CARES Act was signed into law in late March. Included in this $2.2trn package of measures, it laid out $290bn of economic aid payments to US citizens, including a cash payment of $1,200 per adult and $500 for each dependent.

One of the team has a US wife and he shared a copy of the cheque. Various things are striking. The first is that the payments have happened at all, evidencing the sheer scale of the economic damage wrought by this virus. One also notes the "void after one year" text, typed just below the $2,200 amount. The aim is to force people to spend, not save; that makes sense given that household consumption equates to 68% of GDP.

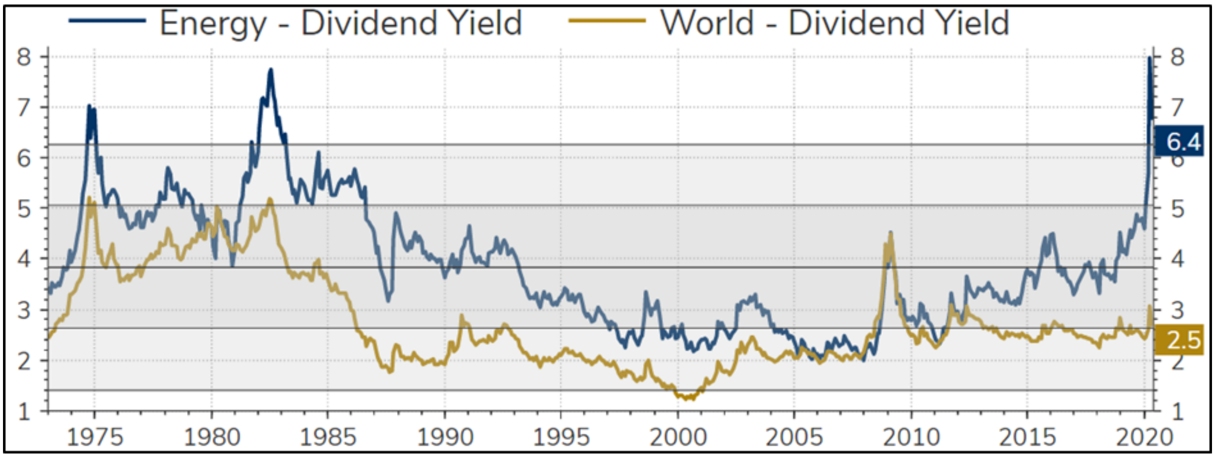
Finally, we can but admire the sheer chutzpah of 'The Donald'. With a November election looming, he could not resist the chance to electioneer, stamping the cheque "Economic impact payment, President Donald J. Trump"!

Energy Stocks — Liquid or Fool's Gold?

Energy stocks are truly unloved. In late April, Microsoft was twice as valuable as the entire US energy sector (the S&P1500 energy index). The Datastream chart below goes back to 1980 and shows the price-to-book (P/B) ratios of the global energy supermajors (blue line) and the World equity market (gold line). The lower the value, the cheaper the stocks are on a P/B basis. Whilst both lines slumped during the recent market falls, the supermajors hit a 4-decade valuation low, both nominally and relative to the wider equity market.



The same is true of the dividend yield (the panel below) although, as Shell proved, many payouts will be cut before this recession has blown through.



If you own energy stocks, you have to believe that fossil fuels will be a meaningful piece of the global energy jigsaw for the foreseeable future. We do. You also need to expect a firmer oil price.

During the first quarter, two key production blocks, Russia and OPEC, fell out. Having previously agreed to limit output, Russia reneged and OPEC retaliated by boosting supplies. Coming at the same time as COVID19 demand destruction, the oil price collapsed. Indeed, due to excess supplies at Cushing in America (where the WTI crude price is struck), the cost of a WTI barrel of oil briefly went negative as supply overwhelmed finite storage.

Since then, the oil price has recovered its composure with WTI now trading at $35/barrel. With US shale oil producers struggling to deliver positive cash-flows at $57/barrel (let alone profits) during 2019, US onshore production is collapsing; the Baker Hughes rig count, a measure of US and Canadian drilling activity, has slumped to 222. It was 700 at the turn of the year and 1,600 during the 2014 shale oil heydays. This will reduce excess global supply. A much wider lack of investment in new oil fields over the last decade and a gradual pick-up in economic activity from the pandemic lows will also bring greater balance to the global oil supply/demand equation.

If you also consider the sector an inflation hedge, given its correlation to a dollar priced commodity, it makes global energy stocks an interesting risk/reward. As such, we have started to build a dedicated exposure in client portfolios.

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 Sustainable yield Japan	Inflation-linked, Emerging Market	Gold
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

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

	31 May 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2343	-2.0%	-3.7%	-2.3%
CHF	1.0402	0.4%	0.4%	4.1%
AUD	0.6667	2.4%	2.3%	-3.9%
JPY	107.8300	0.6%	-0.1%	-0.4%
EUR	1.1101	1.3%	0.7%	-0.6%
BOND YIELDS (10 yr)				
UK	0.18	-0.05	-0.26	-0.70
US	0.65	0.01	-0.50	-1.47
Germany	-0.45	0.14	0.16	-0.25
Australia	0.89	-0.01	0.07	-0.57
Japan	0.00	0.04	0.16	0.10
EQUITIES				
US. S&P 500 (USD)	3,044.31	4.5%	3.0%	10.6%
UK. FTSE 100 (GBP)	6,076.60	3.0%	-7.7%	-15.2%
FTSE Europe Ex UK (local)	248.90	4.1%	-5.6%	-2.4%
Japan. Topix (JPY)	1,563.67	6.8%	3.5%	3.4%
China. Shanghai Comp (RMB)	2,852.35	-0.3%	-1.0%	-1.6%
HK. Hang Seng (HKD)	22,961.47	-6.8%	-12.1%	-14.6%
Australia. All Ords (AUD)	5,872.20	4.9%	-9.8%	-9.5%
FTSE Asia Pac ex Japan	490.00	0.0%	-6.2%	-4.7%
FTSE World (USD)	599.34	4.5%	-0.3%	4.0%
FTSE World (GBP)	718.73	6.6%	3.0%	6.0%
COMMODITIES				
Oil (WTI)	35.49	62.4%	-21.5%	-32.3%
Gold	1730.27	2.6%	9.1%	32.5%

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