Market Review

First quarter 2020

EQUITIES:	Fastest bear market on record as COVID-19 and recession fears spread
BONDS:	Treasury yields at all-time lows, but credit markets freeze
CURRENCIES:	The Fed intervenes to cap the dollar as EM currencies tumble
COMMODITIES:	Russia/Saudi “war” sees oil back at U$20/bl, but gold provides protection

On 19th February, the American stock market (the S&P 500 index) closed at a record high. Just 2 weeks later it had entered into a bear market on its way to an intra-quarter loss of 34%. Many other equity indices fared even worse in response to COVID-19, a Saudi/Russian oil spat and an unprecedented global economic shutdown.

We sympathise with a commentator who described the outlook as “depression-like economics, but 2008-like markets”. The economic data is already dire, but the speed and scale at which the global authorities have deployed record stimulus should prevent a repeat of the 1930s. Most Central Banks have slashed interest rates to 0% (or lower) and deployed trillions of dollars-worth of liquidity-boosting policies. Governments have also displayed far greater intent compared to their financial crisis response; the Financial Times estimates that since the pandemic began, the average G10 state has committed to spend the equivalent of 4% of GDP. Further intervention appears inevitable as the economic clouds darken.

We are now in the unchartered territory of Central Banks directly funding government deficits, which will have long-lasting economic, social and political consequences. But the unprecedented, global stimulus should also help limit the eventual stock market declines to “only” 40-50%; the usual downturn during a recession.

We entered 2020 with a defensive bias, centered around US treasuries, gold bullion, cash equivalents and low equity exposure. We took additional steps to defend capital during the quarter, helping limit portfolio downside. Our next focus is buying quality assets when emotion and fear, rather than underlying fundamentals, push markets to (or beyond) their prior lows.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	-21.3%	-10.8%
FTSE World Equity index GBP	-15.9%	-6.5%

Bear markets tend to unfold in several distinct phases. The initial sell-off can seem innocuous and specific to a particular region or sector. This was the case in January as the first reference by Chinese state media to a "viral outbreak" in Hubei province sparked weakness in Asian equities, but most other stock markets continued their ascent to record highs.

Something then happens to trigger a much broader and sharper downturn. The catalysts this time around were an acrimonious end to OPEC/Russia oil supply cooperation (sparking a deflationary collapse in the oil price) and the WHO announcement just 4 days later that coronavirus was officially a pandemic; the first since 2009's swine flu. In response, stock markets crashed in a largely indiscriminate manner (although the most economically-sensitive stocks fared worst) with forced selling by heavily leveraged speculators compounding the falls. Many of the latter use stock market volatility as a trigger to buy (low vol) or sell (high vol). After the exogenous shock, volatility rises (as measured by the VIX index). Investors sell, amplifying volatility and triggering further sales; a negative spiral. Triggered by Cov19 and the oil markets, the VIX index surged to 85 in March (chart 1), bettered only by its 89 recording in October 2008.

Chart 1: The "fear gauge" hit levels not seen since the banking crisis.

Several relief rallies, which can be of a significant scale and duration, usually then emerge as a "buy the dip" mentality lures some investors back into stocks at perceived cheaper valuations. We saw the first of these complete as the quarter drew to a close with most headline indices rebounding by 15-20% from their March lows.

These rallies then falter as the full economic impact of a recession (which the global economy is now clearly in) dawns. As the fallout intensifies, markets enter the "insolvency" phase that sees headline indices continue to fall for several months until most investors capitulate; that is the best time to buy. We are likely entering the "insolvency" stage now. It tends to be more discerning; good stocks (robust business models, manageable debt burdens, sensible management teams) should do relatively well as the bad ones go bust (or, in this case, seek Government assistance).

Looking more closely at the past quarter, it is no surprise that Chinese shares were the first to suffer. The Shanghai Composite slumped 12% in January during an extended lunar new year break as the Chinese authorities locked down Hubei province. Factories shuttered and consumers stayed home. The dramatic economic impact became apparent with the February survey of China's manufacturing activity; it contracted at a record rate (chart 2). It would prove to be harbinger of how bad the economic data would become elsewhere.

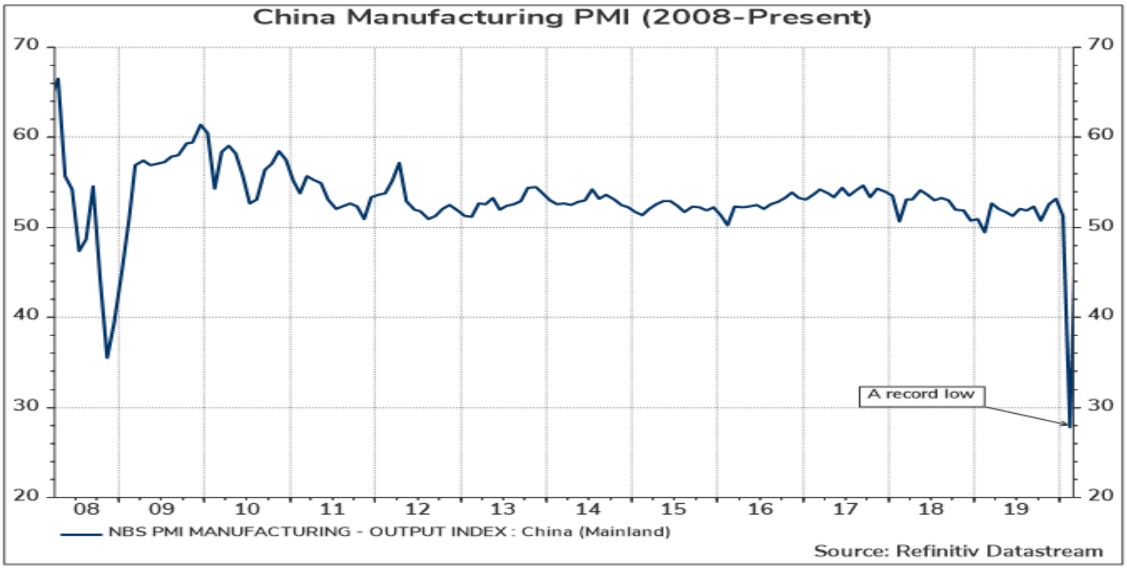

Chart 2: Chinese manufacturing activity has collapsed.

Chinese stocks recovered in February as the growth rate of daily corona-cases peaked. As we moved through March the economy started to recover as restrictions were gradually lifted; activity remains well-shy of its prior peak. However, it became clear that even as domestic demand recovered, the global spread of the virus had caused external demand to evaporate. The stock market turned lower again, finishing down 10% for the quarter (ironically, one of the least affected markets). After solid returns in 2019, we continue to hold dedicated A-share exposures across mandates.

Elsewhere in Asia, having lagged the MSCI World index by 15% in 2019, the Hang Seng fell 16% as the economy remained in the doldrums after almost a year of social unrest and virus fallout. Retail sales are currently 44% lower than 12 months ago, which is why the HK government was amongst the first to deploy "helicopter money" with its promise of a HK$10k handout to every resident later this year.

In terms of virus cases, Korea was initially one of the hardest hit, but the spread was quickly contained, helping to limit the Kospi's losses to 20%. In general, the Asian response to Cov19 has been the most efficient and effective, informed as it is by SARS and other prior outbreaks. This may help limit the duration of lockdowns allowing the region's economies to bounce back reasonably quickly. A second outbreak would undermine this relatively positive outlook.

The same cannot be said for India, which saw some of its worst ever market falls as the Modi government asked 1.3bn people to self-isolate. The virus is only now starting to make its way through the world's most populous country and investors are understandably concerned its healthcare system (and economy) will be overwhelmed. The Sensex fell by 29%. Similar fears pervade Latin American markets, which are facing the double-whammy of the COVID-crisis and a collapse in resource prices; the political response has also been hamstrung by "Trumpian" denial. The markets most sensitive to the oil price experienced a torrid quarter; the Brazilian Bovespa fell 37%, having almost halved at one stage.

Japan has been one of the few countries to eschew the most draconian containment measures. Some may argue that with less than 2,000 confirmed cases they have no need for them, although a low testing rate is a factor. Others suggest that Prime Minister Abe has delayed action to prop up an anemic economy and to avoid cancelling the July Olympics: widely seen as his "swansong" event. The Japanese economy slumped 6% (annualized) in the pre-virus fourth quarter, borne of another consumption tax hike; the contraction will accelerate in the first half of 2020. The Topix fell by 19% last quarter with the Bank of Japan's (growing) direct purchases of equity ETFs preventing greater falls.

The US is amongst the worst hit countries, both in terms of the human cost and the economic impact; GDP is currently contracting at up to an annualized pace of 30%, akin to 1930s depression levels. For context, the US economy shrank by 4% peak-to-trough during the 2008 financial crisis. The unemployment rate is expected to spike from its record low around 3% to at least 20%; the fact that 10 million Americans filed for unemployment welfare in the final 2 weeks of March (chart 3) suggests these shattering projections are not hyperbole.

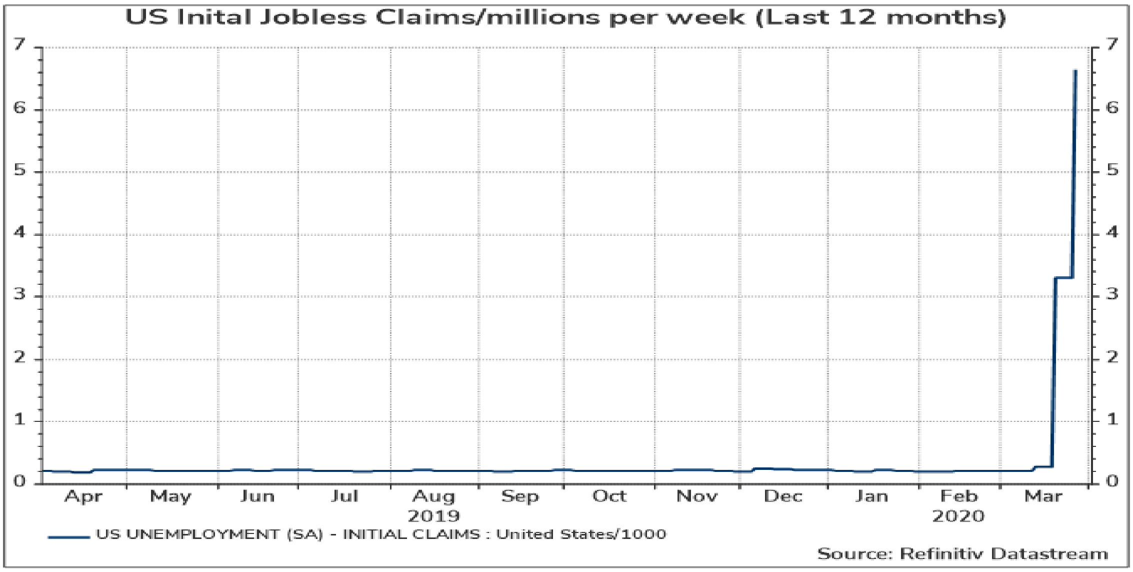

Chart 3: The number of US workers claiming benefits has hit Depression levels.

This could have huge implications for the November election given that the President has taken credit for a "booming" economy and the equity bull market. That said, after the unexpected turns in the Democratic primaries, it looks like he will compete against rather lackluster former VP, Joe Biden. Perversely, given his initial virus denial, The Donald's popularity has risen of late; as the sad chaos unfolds, this resurgence will surely be tested.

The S&P 500 index lost a third of its value before a late rally (driven by stimulus news) curtailed its quarterly decline to 20%. The scale of the fiscal and monetary support is already unprecedented; the Fed cut rates by 1.5% (to 0%) and announced numerous liquidity-boosting measures, whilst Congress passed a U$2trn package for businesses and households. The latter includes a version of "helicopter money" with 90% of US households set to receive a cheque from the government over the coming months; U$1,200 per adult and U$500 for each child, depending on the family's total income. However, like elsewhere, our initial calculations suggest the support may not be large or timely enough to counter the biggest economic shock in a century.

After a year of export disruption from the US/China trade war and a decade-long "hangover" from the banking crisis, the European economy is in no fit shape to handle the pandemic. Sadly, this is particularly true of the larger southern states, which have seen the greatest loss of life despite their world-class healthcare systems.

The growing discord between EU governments has been a notable feature of their crisis response, which again questions the future of the Eurozone. The result has been a relatively lackluster fiscal response (equivalent to only 2% of GDP) amid brewing tensions between wealthy northern states (Germany, the Netherlands) and the more indebted French/southern nations over how to finance it. The latter want to launch "corona-bonds", backed by all member states, thereby pooling liabilities. The German constitution forbids this. We have often seen the Eurostoxx banking index as a barometer for European political and economic risks; it fell 45% intra-quarter, leaving it 30% beneath its record low. Despite evident cheap valuations, for now we remain absent European equities for all mandates (bar Euro-denominated).

Three months ago, we shared our optimism over the "Boris bounce", deeming the easing of political uncertainty as a likely prompt for a UK recovery of sorts. COVID-19 means all bets are off; the UK economy is now entering a deep recession. The FTSE 100 tumbled 25% last quarter as heightened stress amongst the oil majors and dividend cancellations by the top 5 banks (at the regulator's request) amplified the downside. The move erased 8 years' worth of capital gains and took the index back to a level first seen in 1997.

The mid-cap FTSE 250 fared even worse with a 31% decline, having been down 42% intra-month. Most UK firms are facing major headwinds, but smaller companies seem particularly exposed. Unlike their large-cap peers who can secure financing from an array of providers, small firms may struggle.

The government has been quick to respond with the new Chancellor, Rishi Sunak, effectively delivering 3 Budgets in less than a month (he only took over the role on 13th February). He has so far announced £60bn worth of support (3% of GDP) in the guise of wage subsidies, increased welfare support and help for the self-employed. A £330bn loan guarantee scheme for businesses has also gone live, although anecdotal evidence suggests it may be some time before the cash reaches those who need it most; a challenge also being encountered in the US and EU. We significantly reduced our exposure to UK mid-cap stocks as soon as the severity of the situation became clear.

Bonds

10-year yield	31.03.20	31.12.19	30.09.19
US treasury	0.67%	1.92%	1.67%
UK gilt	0.36%	0.82%	0.48%
German bund	-0.48%	-0.19%	-0.57%
Australian treasury	0.77%	1.37%	1.02%

A collapse in inflation expectations and a general bid for safety ensured government bonds were one of the few assets to produce gains over the quarter. The US 10yr Treasury yield began the year around 2%, but by early March had registered a record intraday low of 0.3%. It retreated to finish the quarter around 0.6%, ending the quarter with an 8% price gain. Similar moves were replicated across the sovereign debt complex to the benefit of our high quality bond holdings.

The Fed's record-breaking response to the crisis has been replicated by most other Central Banks. The People's Bank of China has been the outlier, offering more considered assistance; vast accumulated debts from past crises have limited their room for maneuver. So far, the Chinese authorities have injected support worth around 3% of GDP. In 2008, their stimulus equated to 13% and was credited as saving the "great recession" from morphing into a depression.

Elsewhere the support dwarfs anything seen during the 2008 crisis. In a matter of days, the Fed slashed its benchmark rate by 1.5% to 0% and announced a raft of other measures including an additional U$700bn of QE. 8 years ago, when QE3 was underway, the Fed bought U$60bn of US government and agency bonds per month. They are currently purchasing U$125bn of bonds per day; hence why treasury yields of all maturities have fallen to record lows. Whilst yields could fall further, towards the zero bound, the upside looks capped. A growing number of policymakers are endorsing "yield curve control", where the Fed defends a yield ceiling, as it did during World War II.

In the UK, Mark Carney's final act was to cut the Bank of England's target rate to a record low 0.1% and increase its QE program by £200bn. His successor, Andrew Bailey, quickly reinforced the move, stating that the Central Bank "must act in a coordinated manner with the government"; further hints that we are entering a new era in which Central Banks directly finance government spending. The 10yr gilt yield fell by 0.5% to 0.4% last quarter, but the lockdown means the availability of credit (rather than the cost) is the bigger threat. In the UK and beyond, this is a solvency crisis.

Despite some early reticence, Christine Lagarde announced the ECB would spend another €750bn on "flexible" asset purchases, which effectively means it can buy whatever it wants to anchor rates. Down Under, the Reserve Bank of Australia cut rates to a record low 0.25% and announced QE for the first time ever; Philip Lowe seems resigned to the fact he will be the first RBA Governor in 3 decades to preside over a recession. The Aussie 10yr yield finished the quarter just below 0.8%, down 0.6%. This also weighed on the currency, which ended March around a record low U$0.61. Both moves benefitted our Aussie mandates, given their exposure to domestic bonds and overseas assets.

Many emerging market and corporate bond markets ceased up for periods last month as market makers struggled to deal with a deluge of sell orders. Credit markets saw their largest outflows on record as investors fled from a looming surge in downgrades and defaults. The US High Yield bond ETF, which many investors (excluding ourselves) have deemed a "low risk" allocation over the past decade, produced an equity type drawdown of 22% as “junk” spreads spiked from 3% to over 11% in short order (chart 4). Few sectors were immune, but the aggregate yield on energy issues was the main culprit. They ballooned to an all-time high of 22% above the Treasury equivalent.

Chart 4: US “junk” spreads have spiked to distress levels

The Fed’s move to start buying short-dated, investment grade bonds and credit ETFs (something it didn’t do in 2008) reduces the risk of a prolonged liquidity crunch, but a record U$10trn of non-financial US corporate debt is now outstanding with a third of it rated BBB, just one notch above “junk”. The threat of further losses in credit markets remains elevated, but any further widening of spreads will price in an extreme default cycle. We expect panic driven spreads to offer us an opportunity to buy some decent income-generating assets, higher up the capital structure, before too long.

Currencies

Rate versus USD	31.03.20	31.12.19	30.09.19
GBP	1.242	1.326	1.229
EUR	1.103	1.121	1.090
AUD	0.613	0.702	0.675

Even though the US looks set to be one of the worst hit countries, the greenback remains the world’s reserve currency and continues to attract a safe-haven bid during times of stress. The DXY index rallied by 8% in a 10-day period in March when “risk-off” sentiment was at its most extreme; its subsequent 4% decline, in response to the Fed’s support, fueled the bounce in equities. We remain of the view that a return to a sustained period of “risk on” will only emerge once the dollar rolls over and suspect that we could see coordinated intervention to manage the greenback lower if it continues to climb.

Will this happen anytime soon? As ever, currencies are amongst the hardest assets to call, but the Fed has clearly resorted to a “whatever it takes” mindset and it seemingly has the desire (and firepower) to cap the dollar. This was highlighted last month when it reinstated FX swap lines with 14 Central Banks, offering them limited (but plentiful) access to US dollars to help alleviate stresses in offshore funding markets. The latter contain at least U$12trn of dollar denominated debts. These swap facilities proved particularly effective in 2008 and they seem to be working this time too. Over time, the dollar will likely depreciate if the Fed amplifies its "all in" approach and the US government continues to run record budget deficits; after the recent fiscal boost, the US government debt/GDP ratio will soon eclipse its WW2 peak of 120%, up from 107% in late 2019. We also note that Trump is a soft-dollar advocate.

In the meantime, many emerging market currencies will remain under pressure. Those most exposed to resource prices were last quarter's laggards with the Brazilian real, Mexican peso and Norwegian krone all losing more than 30% peak-to-trough. They are unlikely to rebound strongly until commodity markets find a floor, although valuations are starting to look interesting. Conversely, the Chinese renminbi has held up well, losing only 2% against the dollar. Although the economy is contracting at a pace not seen since the Mao-era, the PBoC's reluctance to deploy more stimulus has supported the currency. We remain in two minds about the renminbi, as the slowing domestic economy suggests it could soften over time.

Back in the West, we are watching the euro closely given our renewed existential fears for the EZ's (see above). It finished a volatile quarter just 2% lower against the dollar, but remains weak at just U$1.10. At one stage, sterling was in freefall, but staged a late recovery to finish the quarter at U$1.24; a loss of 6%. Having flourished in late 2019, the reversal of the "Boris bounce" was compounded by the BoE's aggressive intervention and the government's sharp U-turn on Osborne's austerity agenda. The UK's fiscal deficit looks set to hit a "war time" like 10% of GDP soon, causing some of the ratings agencies to downgrade Britain's creditworthiness. Usually this would put upward pressure on gilt yields, but not when the Central Bank has committed to significant purchases.

Commodities

% change	3 months	12 months
Oil (WTI)	**-65.6%**	**-66.8%**
Gold bullion USD	**3.9%**	**21.8%**

The oil and industrial metals markets have borne the brunt. With vast swathes of the global economy closed for business, oil demand has collapsed from its 2019 level of 100 million barrels per day (mbpd). The supply side has also been a headwind despite many production facilities being forced into hibernation. In early March, Russia announced the termination of its 4-year agreement with OPEC that had collectively cut production by 2mbpd; an intervention that propped up the oil price.

Tensions between Russia and Saudi Arabia had been brewing for a year. The fallout of this schism is a flood of new oil into an already over-supplied market. The oil price fell 30% on the day of the announcement on its way to a 66% quarterly loss; Brent crude finished March trading at U$23/barrel, a multi-decade low (chart 5). The cynical take is that this was a pre-agreed strategy to kill off parts (most) of the US shale industry, which has been the dominant price-setter since 2014. The state-backed Russian and Saudi energy operations can better withstand oil at U$20/barrel than the mainly privately-owned, and heavily indebted, US shale firms. The latter needs c. $45-50/barrel to break even. An already depressed energy equities sector took another lurch lower. It is now generationally cheap on a nominal basis and relative to other sectors; an exposure is under active consideration.

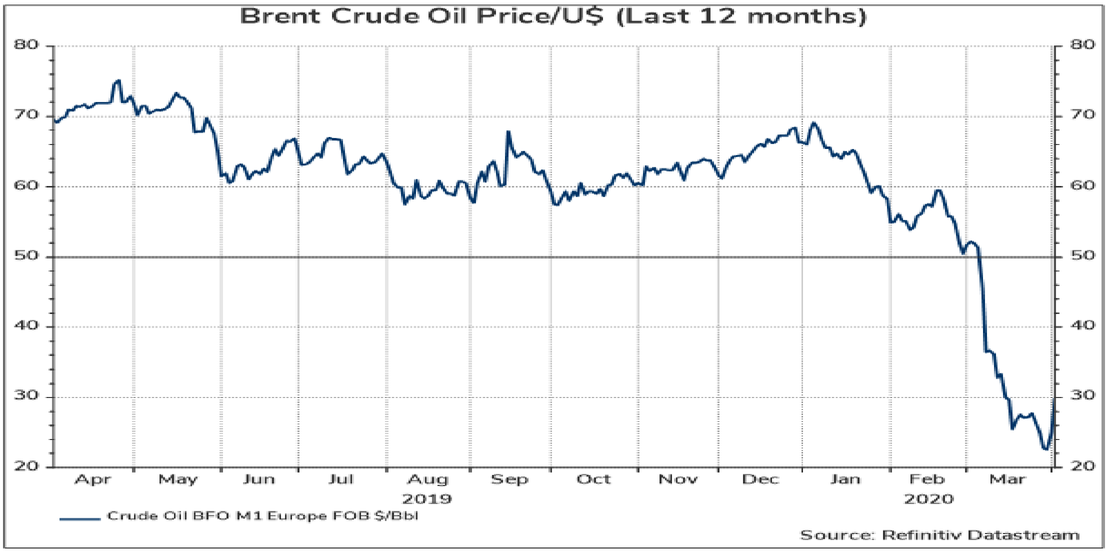

Chart 5: The Russia/Saudi "war" sees oil collapse towards U$20/barrel.

Gold bullion provided some valuable insurance in our mandates last quarter, rising by 4% in dollar terms to U$1,577/oz. However, it endured a 10% drawdown mid-March during the more intense phase of the equity and credit market sell-offs. That was also the case in late 2008 when gold (and government bonds) were used as liquid funding chips by speculators covering margin calls on other losses. We draw comfort from the fact that bullion's drawdown was much lower than the 21% hit it experienced post the Lehman Brothers bankruptcy. It stands to benefit handsomely from the massive amount of global stimulus as real yields fall, inflation fears/risk rise and fiat money is debased.

The physical supply of gold has stalled in recent weeks with a number of mines, refineries and dealers being forced to curtail their operations. This has also supported the gold price, given the surge in demand for "physical" gold products, such as bars and coins. Bullion and the related miners remain a core allocation across client mandates; we topped up on mid-month weakness.

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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