Market Review

Second quarter 2020

EQUITIES:	Virus hopes and stimulus fuel a record-breaking relief rally
BONDS:	Credit benefits from Central Bank buying and near-0% sovereign yields
CURRENCIES:	Little change last quarter, but FX volatility set to rise soon
COMMODITIES:	Oil trades negative as the gold bull market gathers strength

Although equity markets have bounced strongly from the March lows, buoyed by massive stimulus and hopes that the worst of the pandemic has passed, most indices remain significantly lower for the year-to-date.

An imminent V-shaped economic recovery has now been discounted by stock prices; conversely, government bond markets continue to focus on the disruptive, deflationary impact of the virus. Sovereign yields remain anchored close to 0% and in some cases below; the UK gilt market has become the latest to register negative yields.

Gold and other precious metal markets enjoyed another strong quarter, benefiting from investors seeking to protect against renewed economic weakness and the potential inflationary consequences of unprecedented monetary and fiscal stimulus. Our bullion and gold/silver miners' positions were a key driver of portfolio gains last quarter.

The outlook for both economies and markets is intensely uncertain. As the crisis rumbles on, it is easy to paint a bleak picture for consumer and business activity which should, in theory, spark a resumption of the bear market; our core scenario. However, it is possible that further policy support amplifies the disconnect between share prices and economic reality, driving valuations far beyond earnings fundamentals.

If a "don't fight the Fed" mentality prevails over the coming months we may need to temper our defensive stance; we remain open minded. In the meantime, portfolios are benefiting from the rebound in stock markets and the strong rally in bonds and gold. Having avoided the worst of the recent bear market, most portfolios are close to flat or marginally up over the last twelve months despite the intervening turmoil.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	19.3%	2.7%
FTSE World Equity index GBP	19.5%	5.3%

It is normal for bear markets to be interspersed with short, sharp relief rallies but the scale of the gains during the second quarter has surprised us. Most stock markets have rebounded 15-20% over the past 3 months, but remain down double-digits for the year-to-date.

There are various reasons why we believe this is a temporary, albeit aggressive, rally within an ongoing bear market. The economic situation remains dire with US GDP set to contract at an annualised pace of 40% in Q2; the UK and EU are similarly challenged. After such a brutal downturn, economic activity usually takes years, not months, to regain prior peaks. Whilst consumer activity is rebounding as lockdowns ease, spending levels remain way below year ago levels. Chart 1 shows US retail sales are still down 6% year-on-year (consistent with a deep recession) despite a record 18% monthly surge in May.

Chart 1: US consumption remains far below pre-crisis levels.

With the virus either accelerating or reappearing in multiple global locations, the recovery will likely be disrupted well into 2021. A key consideration will be how household and business confidence evolves. Media reports of mass redundancies and over-burdened hospitals will likely discourage consumers from spending freely on discretionary items; indebted companies will, in turn, favor balance sheet repair over expansion. We are monitoring a variety of sentiment indicators as key forward looking gauges of private sector growth.

There is also the question of who exactly has been buying stocks; institutional investors remain (largely) cautious. The answer lies in an army of new day traders that have embraced speculation as a lockdown distraction. Millions of new online brokerage accounts have been established in recent months (most notably on the commission-free, Robinhood platform), as the rising tide of unemployed use enhanced benefits to punt cheap, depressed equities. 'Davey Day Trader' is the self-appointed head of this merry band. In June, he led an army of retail investors who (temporarily) pushed the Hertz share price up more than 600%, only days after if filed for bankruptcy. This speculative frenzy has uncomfortable parallels to the months running up to the peak of the dotcom bubble.

US equities were amongst last quarter's best performers with the pandemic's "stay at home" winners (tech, healthcare and online retail) leading the gains. Only the gold miners outperformed these sectors as the highest average quarterly gold price on record (U$1,712/oz) and tumbling energy costs boosted profit margins. With most institutional investors still underweight or absent the gold miners there is plenty of scope for further flow into the sector. Both bullion and the gold miners remain amongst our highest conviction calls; we added to the latter last quarter.

Conversely, some of the cheaper, more economically-sensitive "value" names continue to struggle. Faced with a flat yield curve and rising delinquencies, financials stocks have been notable laggards; seldom a sign of an improving economy. It is also increasingly clear that the virus poses an existential threat to multiple businesses in the retail, hospitality and travel industries despite unprecedented levels of government support; insolvencies are rising and will continue to do so.

We have though initiated an investment in the deeply unloved energy sector, via an ETF with a bias towards the supermajors. Having lost nearly 2/3rds of its value since 2018, the fund has rallied off its March lows despite a raft of dividend cuts and the oil price slumping to a record low of minus U$37/barrel (see commodities section). When stocks rally on bad news it is typically a sign that valuations have troughed and, despite the cuts, dividend yields still remain far above cash and bond equivalents. We intend to add further in due course.

The continued outperformance of growth stocks leaves the S&P 500 more concentrated than ever with the top 5 stocks (all tech names) accounting for c.22% of the index. Whilst we do not question the enduring merit of many tech companies, valuations are approaching levels not seen since the last tech bubble burst (chart 2). With such narrow leadership, any stumble from Google, Apple, Facebook and the like could have implications for the wider market.

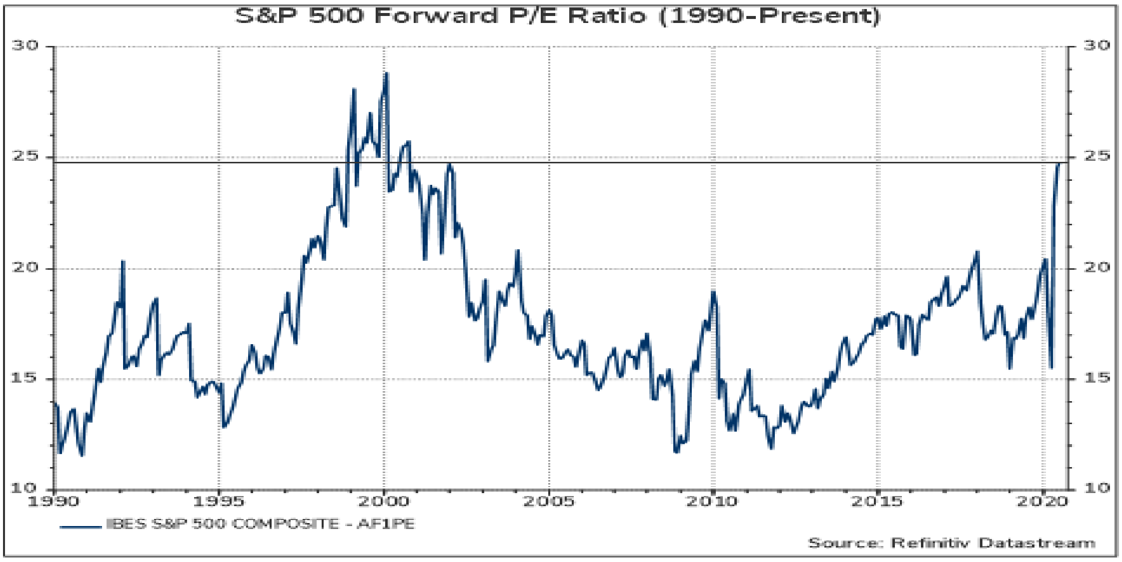

Chart 2: The S&P 500 now trades on a forward P/E multiple of 25x; a 2-decade high.

The next 6 months will be key for the US tech titans. Their business models are increasingly cyclical with an outsized exposure to capital expenditure and the slump in global advertising spend; Google and Facebook generate 70% and 99% of their revenues from advertising, respectively. Talk of breaking up dominant tech oligopolies is also set to intensify as we head towards the November election. In just 3 months, Trump has flipped from a shoe-in to the underdog. The betting exchanges now firmly favor a Biden victory, whilst a Democratic clean-sweep of both houses of Congress is no longer a wild card. If that happened, Biden has pledged to explore antitrust legislation, to rein in the Silicon Valley leviathans, and to reverse the Trump corporate tax cuts; a move that could lop up to 15% off post-tax profits.

After April's 20% monthly collapse in GDP (by far a record) the UK is on track for its worst recession since the Great Frost of 1709. A muddled policy response to coronavirus and the growing likelihood of a Hard Brexit also contributed to UK equities' material underperformance last quarter; the FTSE All-Share managed only a 10% rebound, leaving it down 19% year-to-date.

At the time of writing, about 9mn UK workers are having all or part of their income paid by the furlough scheme at a cost of over £25bn; that's about a quarter of the total workforce. With an unknown (but significant) number set to lose their jobs over the coming months as these policies are tapered, we have a relatively downbeat outlook for the UK economy; a far cry from last year's "Boris bounce". Consequently, we have used the rally in mid-caps to switch away from the more domestically-focused FTSE 250 holdings into multinational yield plays, with a bias to the defensive consumer staples and utility sectors.

Over the channel, European bourses fared better with many EZ countries handling the crisis relatively well. Having flattened the infection curve, economies are re-opening to a "new normal" without a meaningful surge in covid-cases (so far). An ultra-supportive policy backdrop has also been influential. After some early reticence, European Central Bank (ECB) President Lagarde has pledged to provide unlimited liquidity and a normally-austere Germany has become the standard bearer for fiscal intervention. Chancellor Merkel has agreed to spending plans and tax cuts amounting to more than 10% of GDP. However, long term structural challenges remain and the pandemic has had an outsized impact on the all-important trade and tourism sectors. As a result, we remain underweight European stocks, favoring other areas for cheap, cyclical exposure.

Indeed, Japanese equities were a notable winner last quarter. Having spent 3-decades dealing with deflation, Japanese corporates offer a highly geared play on any reflation; global or domestic. We retain a sizeable allocation across equity mandates and may add further if deflationary winds abate.

In the meantime, Japanese stocks are supported by very cheap valuations and robust balance sheets; over half of the Topix constituents hold net cash (cash balances exceed debts), in stark contrast to the many highly-geared Western corporates. However, political risks are brewing, with the government recently ruling that any overseas investor owning more than 1% of a Japanese company's must notify the authorities; the prior threshold was 10%. Given the local equity index is heavily influenced by foreign investment flows, a return of market xenophobia bears watching.

Counterintuitively, Chinese equities have been relatively sheltered this year. They likely benefited from being the first to enter and exit the initial wave of the crisis. Seemingly efficient virus control also suggests a relatively short, sharp economic shock. The mainland index gained 9% last quarter and is only down 2% for the year-to-date; the best-performing major bourse and one to which we retain a meaningful exposure.

This does not mean that China has been immune to the economic malaise; Q1 GDP contracted by a record -6.8% y/y. Consumer activity remains way below pre-lockdown levels and export demand is sluggish. This speaks to sub-par future growth, especially if US/China relations get caught up in the November US Presidential campaign. That said, Chinese equities can be heavily influenced by liquidity flows and covert Government support. With the PBoC finally dialing up its monetary support the position looks well-bid for the time being.

On June 30th, the Chinese authorities signed a law into Hong Kong's mini-constitution that criminalises behavior that the Authorities feel threatens national security. The law was poorly received internationally, with various Governments threatening (as yet) ill-defined retaliation for the perceived erosion of HK civil liberties. It seems too early to judge the day-to-day impact of the law on citizens and business, save to say that it indicates HK's long run future is as an integrated part of the mainland.

Faced with this geopolitical curveball, the Hang Seng managed only a modest bounce last quarter. That said, there may be a silver lining to potential US sanctions. Legislation currently before the Senate will deter Chinese firms from listing on the New York stock exchange. Hong Kong is the obvious alternative for NYSE "refugees" and future IPOs. As long as HK is not shut out of the US dollar clearing system, this promises to be a listing boon.

Bonds

10-year yield	30.06.20	31.03.20	31.12.19
US treasury	0.66%	0.67%	1.92%
UK gilt	0.17%	0.36%	0.82%
German bund	-0.46%	-0.48%	-0.19%
Australian treasury	0.87%	0.77%	1.37%

Volatility of US treasury (UST) yields has collapsed as the Federal Reserve becomes the dominant buyer; it now owns over 20% of all issues. Along with the Bank of Japan and Reserve Bank of Australia, the Fed seems to be indulging in a form of yield curve control (i.e. capping rates by buying bonds). The 10yr treasury yield finished the quarter unchanged around 0.7% pa; a stark contrast to the more optimistic reflationary outlook in equity markets.

By buying vast sums of treasuries, the Fed is effectively funding the US Government. To ward off a depression, the Trump administration is on track to borrow a staggering U$3trn in the second quarter with an additional U$2trn slated before year-end. The eventual figure may be higher; Trump is currently pushing a U$1trn infrastructure bill, whilst the Democrats advocate an additional U$3trn pre-election splurge.

The Fed has committed to keeping base rates at 0% until at least 2022 and will inevitably be forced to expand its balance sheet far beyond the current U$7trn. This should be good for gold bullion given the resulting debasement of the fiat/paper dollar. With such a powerful buyer of last resort in situ, bond yields seem capped for now, so we continue to hold our long duration USTs.

This dynamic also explains our growing interest in short-dated, investment grade (IG) credit as the Fed (and other Central Banks) are becoming increasingly aggressive buyers of corporate bonds. Setting aside a debate about the legitimacy, desirability and necessity of such a move, in just 3 months the Fed has become the 3rd biggest owner of the largest IG credit ETF. Fed intervention prevented a liquidity crisis in the corporate bond market in March, but ongoing efforts are clearly distorting price discovery and efficient capital allocation. Whilst default risks are rising, particularly in the high-yield space, some higher quality/low duration credit issues still offer a cash-beating 2-3% p.a. nominal yield. They also now have the explicit backing of the Fed's printing press if spreads threatened to widen (and prices fall). We are thus establishing an actively managed credit exposure across all multi-asset mandates.

The Bank of England (BoE) has become the first major Central Bank to openly finance government spending via its "Ways and Means" facility; effectively HM Treasury's overdraft facility at the Bank. It has been used on and off since the 17th Century, typically during wartime and financial crises. The Bank's pledge to let this facility run far above the usual £400mn limit marks a significant step beyond QE. It also evidences concern about the UK economy; the Bank has increased its asset-purchase program (by £100bn to £745bn) and is considering negative base rates. The gilt market has taken the hint with short and mid-term yields falling into negative territory for the first time ever (chart 3); the 10yr remains just above zero, at 0.2% p.a.

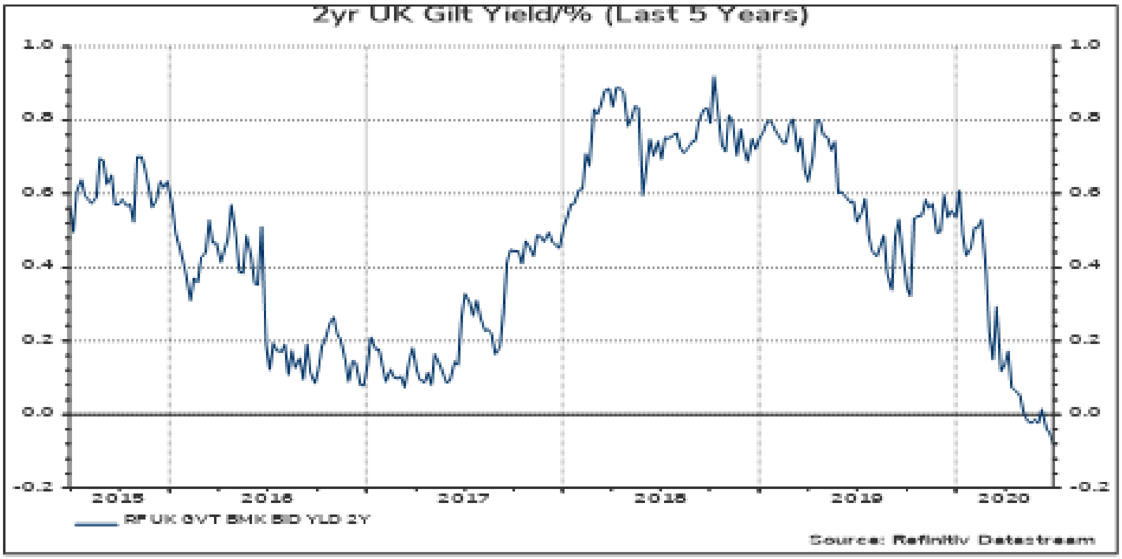

Chart 3: UK gilt yields have fallen into negative territory for the first time ever.

Similar strains in EZ money markets have disappeared thanks to the European Central Bank's (ECB's) intervention. Last month it used the TLTRO program to lend €1.31trn to commercial banks at a cost of -1% pa. We question the efficacy of this policy. The recipients are more likely to use the 'free money' to purchase EZ sovereign debt (thereby earning a profitable, risk-free yield spread) than to lend into the troubled economy. The German Bund yield finished the quarter little changed at -0.5%.

The Bank of Japan continues to anchor the 10yr JGB yield at 0%; it has pledged unlimited buying to hit this target. With the BoJ owning c. 50% of all JGBs, market turnover has collapsed. A fate that lies ahead for some of its Western counterparts?

As noted above, the Reserve Bank of Australia has launched a policy to maintain 3yr yields at 0.25%p.a. This comes in response to the country's first recession in 29 years; GDP contracted by 0.3%

in Q1 with worse to come in the June quarter. The 10yr Aussie yield finished slightly higher at 0.9%p.a. Its failure to rise more questions the reflation trade unfolding in other markets, including the Australian dollar which surged by almost 13%. The Aussie was helped by an upswing in iron ore shipments to China, with the latter taking advantage of depressed prices to stockpile strategic resources (e.g. oil, iron ore and copper). Australian producers have benefited as their competitors in Africa and Latin American closed mines due to the virus.

Currencies

Rate versus USD	30.06.20	31.03.20	31.12.19
GBP	1.240	1.242	1.326
EUR	1.123	1.103	1.121
AUD	0.690	0.613	0.702

It is our belief that the reflationary narrative (and the concomitant equity rally) can only be sustained if the richly valued US dollar starts to soften. We are thus paying close attention to the path of the renminbi and the euro (against the dollar) given their influence on global liquidity and sentiment. Both came close to falling below major support lines last quarter (potentially heralding renewed deflation/risk off pressures), but ultimately finished the period little changed.

Chart 4: The euro downtrend is showing signs of bottoming out.

In Europe, the pandemic may finally have catalysed the first steps to some form of fiscal integration by member states. During May, Merkel and Macron proposed a €750bn euro recovery fund that will offer non-recourse grants to distressed member states. It will be financed by the European Commission issuing mutually-backed sovereign debt; a genuine game-changer if adopted and the first step towards a proper monetary union. However, the “frugal four” (Austria, Denmark, Sweden and the Netherlands) oppose various elements including the provision of grants instead of loans. Whilst the detail may evolve, some form of pooled fiscal fighting fund now seems likely. The euro rallied on the news to finish the quarter at U$1.12. Although the single currency remains in a multi-year downtrend, any credible break above U$1.15 would likely lead to further gains, supporting a possible extension of the reflation trade (chart 4).

Similarly, if the renminbi strengthens below RMB7.05, it may indicate a more constructive outlook for risk assets. It finished June little changed around RMB 7.07 despite the economy's worst performance in recent times. In a pattern that is being repeated globally, production has rebounded far more quickly than consumption, as industry reopens but households remain reluctant to spend. This is unsurprising if the reports of over 100mn people losing their jobs during Q1 are remotely accurate.

It was interesting to see the Chinese officially launch the first digital sovereign currency last quarter. It is pegged to the existing renminbi and is being trialed by some public sector workers who are being paid in this electronic unit. If successful, China could evolve to a predominantly cashless society quite quickly, given the control afforded to the issuer. Other countries will surely follow.

For the reasons outlined above, sterling has struggled to rebound from its first quarter loss; it was little changed at U$1.24 against the dollar. The pound is cheap and is already trading towards the lower end of its historic range. This likely limits potential downside, but currencies are a relative game and the UK's virus struggles will surely remain a drag.

Most emerging market currencies (and debt markets) staged a solid recovery last quarter, but the Indian rupee (flat) and the Brazilian real (-5%) remain under pressure. India experienced one of the more draconian lockdowns, which had a devastating impact on growth; not a single car was sold in April, which is staggering for a country with 1.3bn citizens. Brazil is also having a tough time, as President Bolsonaro's cavalier covid management has birthed a runaway level of infection. There is also a growing risk he will be impeached on corruption charges; a recurrent blight on local politics. With many South American countries struggling to control the virus, as market bounced, we redeemed our Latin American equities positions.

Commodities

% change	3 months	12 months
Oil (WTI)	91.8%	-32.8%
Gold bullion USD	12.9%	26.4%

The WTI oil contract hit a record low of minus U$37/barrel in April as the global shutdown cut oil demand by 20%y/y (source: EIA). This sudden demand shock comfortably outpaced the supply response meaning surplus oil quickly filled all available on-land and tanker storage facilities.

The supply glut at Cushing (where the US WTI oil contract is priced) coincided with the expiry of the May futures contract. With no buyers of physical oil, futures speculators were unable to close out their open positions and were faced by the unpalatable prospect of taking physical delivery. With no room in storage facilities, the near term oil price plunged below zero as speculators were forced to pay people to take delivery of their physical exposure.

These technical pressures soon eased and oil rallied to U$40/barrel by the end of June. The demand outlook improved, with some factories restarting and people swapping public transport for (less efficient) cars. Supply also corrected; US production has fallen 3mbpd/30% from its March peak. Whilst the supply/demand balance will continue to reflect the level of global economic activity, with energy stocks priced for a prolonged, deep recession and the oil price unlikely to revisit its negative nadir, we took the opportunity to initiate an exposure to the energy stocks, having started the research at the back end of last year.

Elsewhere, our conviction in gold and silver continues to grow with both trading strongly last quarter; bullion rallied 13% to a multi-year high of U$1,781/oz and is up 26% over the past 12 months. Silver gained 30%, recouping all of its Q1 loss. The recent performance has been driven by US real (inflation-adjusted) interest rates falling below 0%; the lack of yield on bonds reduces the opportunity cost of owning (zero yield) gold.

The recent policy response also informs our precious metals outlook as the gold price displays a positive correlation to both US money supply growth and a rising US fiscal deficit; both are booming. As chart 5 shows, the US deficit will exceed U$3trn this year (left axis/blue line) and this tends to lead the gold price (right axis) by around 2 years. Given the explicit intention of global Governments and Central Banks to do "whatever it takes" to engender inflation, if history is any guide, precious metals remain the ultimate hedge.

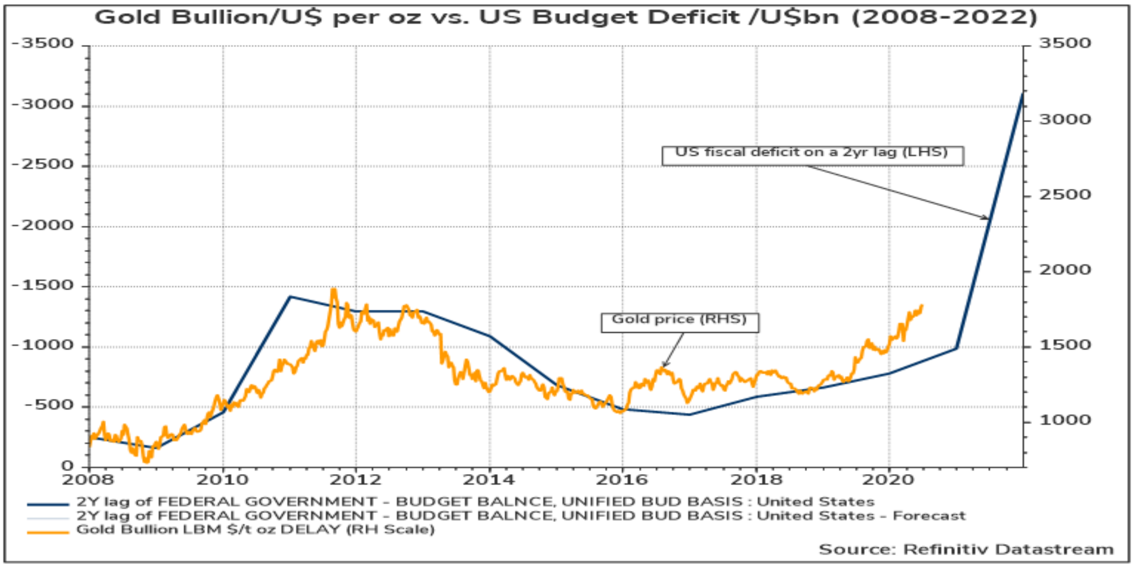

Chart 5: Widening US fiscal deficits tend to lead to a higher gold price.

Market Performance

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

	30 June 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2401	0.5%	-0.2%	-2.3%
CHF	1.0556	1.5%	1.5%	3.0%
AUD	0.6903	3.5%	12.6%	-1.7%
JPY	107.9300	0.1%	0.4%	0.1%
EUR	1.1234	1.2%	1.8%	-1.2%
BOND YIELDS (10 yr)				
UK	0.17	-0.01	-0.18	-0.66
US	0.66	0.00	-0.01	-1.35
Germany	-0.46	-0.01	0.02	-0.13
Australia	0.87	-0.02	0.11	-0.45
Japan	0.02	0.02	0.01	0.18
EQUITIES				
US. S&P 500 (USD)	3,100.29	1.8%	20.0%	5.4%
UK. FTSE 100 (GBP)	6,169.74	1.5%	8.8%	-16.9%
FTSE Europe Ex UK (local)	257.35	3.4%	14.3%	-3.8%
Japan. Topix (JPY)	1,558.77	-0.3%	11.1%	0.5%
China. Shanghai Comp (RMB)	2,984.67	4.6%	8.5%	0.2%
HK. Hang Seng (HKD)	24,427.19	6.4%	3.5%	-14.4%
Australia. All Ords (AUD)	6,001.35	2.2%	17.4%	-10.4%
FTSE Asia Pac ex Japan	527.77	7.7%	18.4%	-2.9%
FTSE World (USD)	615.53	2.7%	18.8%	0.4%
FTSE World (GBP)	738.56	2.8%	19.2%	3.4%
COMMODITIES				
Oil (WTI)	39.27	9.6%	31.8%	-29.6%
Gold	1780.96	2.9%	12.9%	26.3%

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