QUARTERLY MARKET OVERVIEW – JULY 2020

"To expect the unexpected shows a thoroughly modern intellect"
– Oscar Wilde

Looking back, at the start of the year we said we should not underestimate the unexpected but all things being equal 2020 might be a good year for equities. It seemed a bold statement but there wasn't exuberance in the markets, the tensions between China and the US seemed to be calming down, Trump almost certainly was set to win a second term in the White House and there was a strong chance that the UK would secure a BREXIT deal.

In January, the markets reflected this optimism. We, like most others, had heard of Coronavirus assumed it was contained within China. Even when Apple announced concerns about supply chains, we believed this to be short term. We spoke to many people over the subsequent weeks and although there were worries, there was nothing that really pointed towards what happened next.

The falls in the market were caused by three shocks. The first was a deep economic shock unparalleled to anything in modern history. The second was oil related and the 'battle' between Russia and Saudi Arabia. The third was the spike in equity volatility which disrupted the US treasury bond market, leading to equities and bonds all falling at the same time, and a substantial and erratic fall in asset prices.

Very quickly, comparisons were made with the Great Depression. That said, the falls may have looked similar or been greater but there was a difference. Governments knew that mass social distancing (lockdowns) would cause economic problems. It took 5 years for fiscal stimulus to be put in place during the Great Depression. This time it took the US just two weeks and the package was the largest in modern history, and this is reflected globally.

This is also different to the 2008 crisis where the entire financial system was at risk. This is not the case here; COVID-19 responses have a enacted form of socialism, with the furlough scheme in the UK aimed at those on or below the average wage with the primary aim to ensure not only do people have an income but also hopefully a job at the end. It is important to remember that although a handful of countries did this in 2008, the UK was not one of them, but this time around many countries have adopted this approach.

In the US, unemployment benefits have provided more money to some people than when they were working. Over the coming weeks and months, unemployment figures will remain high. In the US it is expected to end up at over 10%. In the UK, over 9 million people have been furloughed and 3 million of those work in the hospitality sector.

The recovery will be slow; looking back at the notes we have shared over the last few months the view has changed from a V shape recovery to a U or W shape. In the short-term we believe areas to watch are:

1. The second wave, however Governments are unlikely to enforce the same levels of lockdown (perhaps locally), therefore we need to understand the potential impact of this
2. China/US trade tensions will ramp up as Trump aims to deflect attention away from the economy, the reality is that the recent agreement benefits the US and it would be crazy to rip that up
3. My view on the US election is that despite the polls and the fact that the US is now in a deep recession, Trump will likely win. It is a bold statement and I will expand on this in the update. The markets are likely to be volatile in the lead up to the election and it is worth considering that a Democratic clean sweep might, in the short term, be bad for markets. A Trump victory might mean the opposite.
4. BREXIT has not gone away, but it seems a miracle is required to get a deal before the end of the year. The UK seems unlikely to want an extension, because potentially we would be locked into paying the EU when the budgets are agreed next year, with no ability to negotiate on the level of payment. WTO rules are manageable but mixed in with the fallout from lockdown, this could make things tricky for businesses

In the medium to long term there are reasons to be optimistic:

1. We could be in a super bull cycle and this is just a reset
2. Coming into 2020 we expected a calm year, there were concerns about a recession but more likely we were in an environment of slowing growth
3. The reset is important, prior to COVID-19 it seemed that interest rates would start to rise slowly, that QE would be unwound and potentially inflation would start to rise. This has all changed as interest rates have come down and will remain low for a long time. Inflation has also reduced and is likely to return to more stable levels, and QE has restarted. These factors are supportive of equity markets
4. There is a wall of cash waiting to go back into markets. This is important because as people hunt for income, they must now climb the risk scale and equities become the only meaningful asset with liquidity which can provide income. Also, as markets recover there is a fear of missing out which drives people to invest
5. Governments will spend their way out of this, and we can expect massive infrastructure spends globally

Over a longer term there are concerns over the level of debt and the comedown from the QE sugar rush.

I would be a brave person to call how the end of this year turns out, as there are economic pressures. We have entered a recession and the speed at which we exit is not known, the lasting damage is yet more uncertain.

However, we can put this against a backdrop where we have only been put back perhaps two or three years to an environment which is very supportive of equity markets.

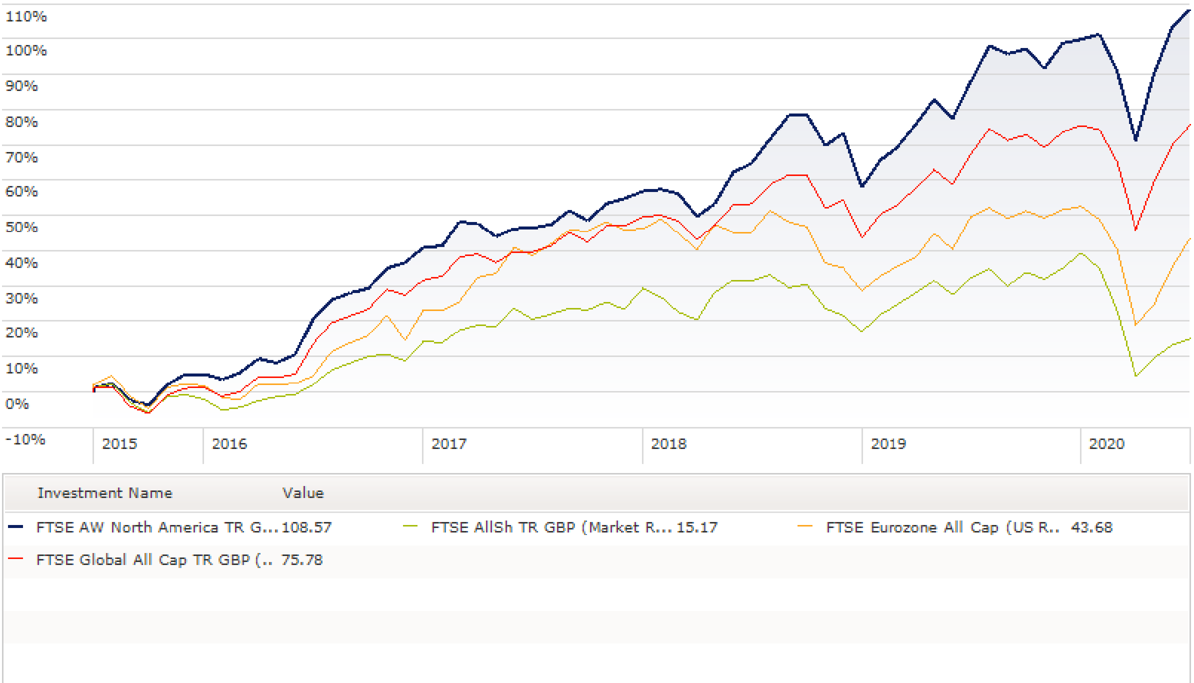
In this update I will share some thoughts from over the last six months, and things to look for going forward.

George Ladds

George Ladds, Director, July 2020

US, EUROPE & UK

Five year returns 1 July 2015 – 30 June 2020



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At the start of 2020 in the UK, we had a strong Government, with a focus on spending. Austerity was no more. There really did seem to be a magic money tree!

Focusing briefly on Brexit it seems very unlikely that the Government will push for an extension, but never say never. The two main sticking points appear to be around the European Courts and Fishing Rights. According to Jupiter Asset Management there are two reasons we might leave without a deal. Firstly, 2021 starts a new round of EU budgets and we could be sucked into this, with no means of influencing what we pay. Clearly, we will not want to do that, especially when we are some way down the road to a trade deal with the US. If we cannot get past the blockages with the EU, then it is unlikely we will extend, and we Brexit on WTO terms.

In the short term there will be a hit to sterling which could mean sizeable economic impact. The general view is that it is better to take this on now, rather than being sucked into a bigger mess if we extend.

Economically the UK has been hit hard, and it is unclear what the level of unemployment will be. If you assume a modest 10% of those on furlough become unemployed, that is about 900,000 people. Currently there are an estimated 1.35 million out of work so this impact could be significant.

We must also count the cost of Government measures alongside a 42% drop in tax take, plus the time everything takes to recover. The UK debt to GDP ratio has now surged above 100% for the first time in almost 60 years, although it is still well below many other developed nations. Interestingly the Bank of England have indicated that QE is not endless, which is different to the Fed and is perhaps a warning to both markets and the Government.

People will need to have confidence to come out and spend, and if people are worried about jobs this might take time to happen. Like many other countries however, interest rates are low, and the Government has pledged a massive infrastructure spend. This is a simple way to re-invigorate the economy. In the short term, relaxing the 2-metre rule (although potentially risky) and cutting VAT are measures which also might help.

In the US, it looked certain that Trump would win the Presidential race, but this has now become a battle over the economy, inequality, and Trump himself. The polls show that Trump is trailing Biden. It is noteworthy that no sitting US President in recent history has been re-elected during a recession. So, the odds are certainly not in Trump’s favour. In fact, there is a growing consensus that the Democrats will win with a clean sweep, which is unlikely to be good for markets.

But Trump should not be underestimated. In the last election he was behind in the polls and still won. This time he is a known entity, which might be his downfall. However, there is a school of thought that many would not admit to voting again for Trump which distorts the polls, so we do not know if they are correct. Trump is a master at distraction and by focusing on China now, this might be enough to take the focus away from the economy.

The US economy came into this behind Europe. Unlike other countries they have exited lockdown but have since seen the number of cases rising in some areas (Texas, Arizona, Florida). Unemployment is at record levels but much of this is temporary unemployment and there is a sense that many of those jobs will be taken back. However, unemployment is expected to be over 10%. There is a concern that some people are currently less willing to return to work because they have been receiving more via unemployment assistance.

Adding to the mix are growing tensions between China and the US. At the start of the year, they entered the first stage of the agreement which would have given significant benefits to the US for trade. It seems crazy that this would be ripped up, but Trump needs to deflect away from the economy and China is an easy target.

Like the UK, the US has pledged significant infrastructure funding, to spend a way out where possible. There are promising signs of recovery from US domestic retail sales and food services, as well as an increase in sales of ‘big-ticket’ items.

Turning to Europe, which remains a region of concern. Outside China, it was the epicentre of COVID-19 with Italy being hit hardest. The EU is a complicated beast and without fiscal unity there is potential for tensions to boil over within the next 2-3 years. Their economy is reliant on tourists and the lack of income could be significantly damaging. Germany has been able to step in with incentives including tax cuts, a helicopter payment to children and a car scrappage scheme. Not all economies can do that.

In Italy, the budget deficit is likely to keep increasing as they work out ways to increase consumer activity and take on state projects to try and reboot the economy. Infrastructure projects will feature heavily, including high speed railways and high-speed internet countrywide. There are also reports of a possible sales tax cut to encourage spending and to turn over the economy more quickly.

This creates the same double whammy for the Italian treasury to deal with, falling tax receipts and increased expenditure. The current deficit is more than 10% of GDP but that is invariably going to increase and though Italy might find itself at the upper end of budget deficit ratios, it will not be alone.

The landscape has shifted since the start of the crisis and it seems that policymakers are not going to make the same mistakes as in 2011. The EU recovery fund is a positive sign and perhaps a step towards fiscal integration. The ECB continues its drive towards being a forward-thinking central bank, which could signal a more unified approach across the EU.

As European states open, the news thus far has been positive (although see below re Germany) and sectors like manufacturing have seen a big bounce. They are still in the contraction phase but certainly heading in the right direction.

Germany saw an increase in the R number of 2.88, a massive jump. This led to some local authorities considering further lockdowns, as they struggled to get people to stick to social distancing rules. Unfortunately, one city needed to deploy riot police to enforce policy. Germany has been the posterchild of the pandemic and for them to now be considering going back into lockdown is concerning, but they should be successful.

Italy's infection and mortality numbers continue to fall. The country exited lockdown at the beginning of June and has so far managed to keep the trend lines moving downwards, though there have been a few clusters of reinfections. Separately, Italian scientists claim that the virus was present in the north of the country more than two weeks before China reported its first cases.

The big question across the western world is how economies pay for all this debt. Austerity should not return whilst interest rates are low, and borrowing is cheap. However, the bill needs to be paid, whether this is an increase in direct tax or via stealth tax.

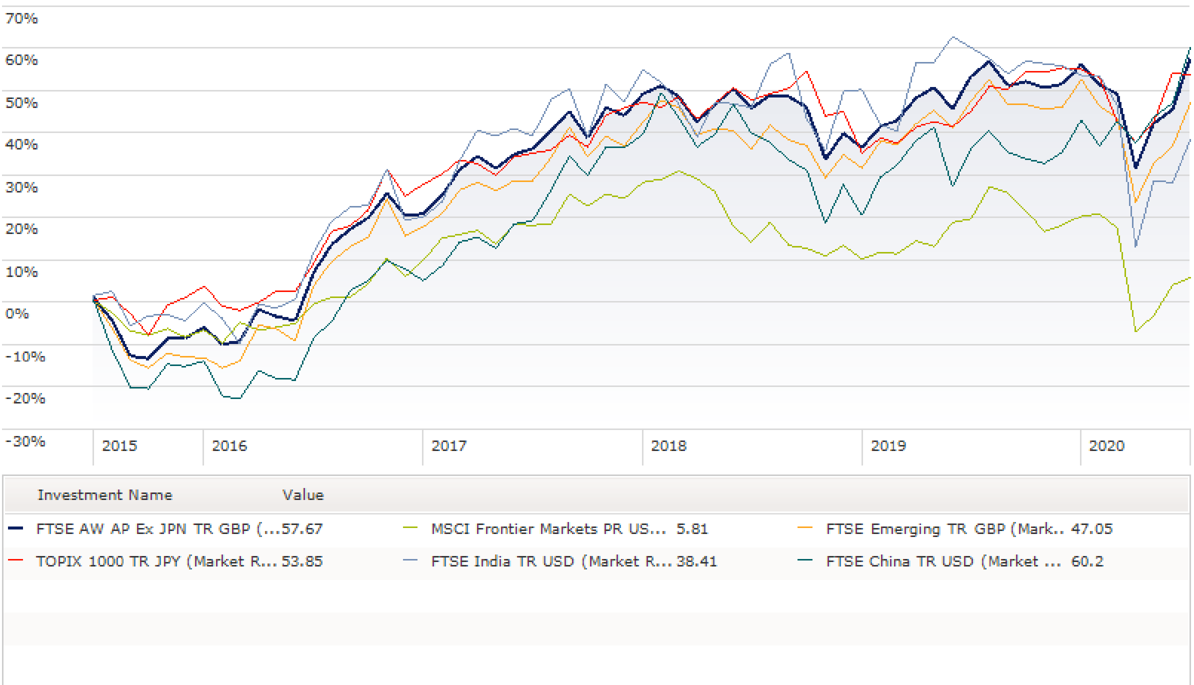
In the UK, this could be solved by removing the triple lock on the state pension, freezing the personal allowance, or unifying national insurance for the employed and self-employed. This should not happen immediately because Governments will not want to derail any potential recovery by taking money away from the consumer.

Data from McKinsey shows us that consumer confidence in the West has declined in the UK, Germany, Italy, and France. The US has picked up but remains low. In the US, 68% of people believe they will need to adjust their routines due to COVID-19 for 4 months or more, in the UK this is 76% and Germany 78%. In terms of income, 52% of people in the US see their personal/household income being impacted for 4 months or more, in the UK this is 58% but in Spain this is 65% and Italy 63%. The most recent data from McKinsey makes for an interesting read and outlines the challenges economies face as they look to rebuild.

In summary, there are various factors to consider. As economies exit lockdown, fears of a second wave could heighten, which could slow any potential recovery. In the short-term economies will be looking to spend. Excluding the second wave, the speed of development of a vaccine/treatment, the US election, the EU recovery fund and Brexit are worth watching.

EMERGING, ASIA AND FRONTIER MARKETS

<u>Five year returns 1 July 2015 – 30 June 2020</u>



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China was at the epicentre of the outbreak and was first to exit. We have written in recent weeks about the signs of recovery, although there remains a concern of a second wave, especially in Beijing but we understand this has been contained.

Some of the positive data from China showed that 93% of the workforce was back at work at the end of April, and industrial production has been positive year on year. It was also interesting to see middle bracket restaurants are 70%-80% full, but at 60% of original capacity. Shanghai Disneyland when opened at 30% capacity, sold out in minutes.

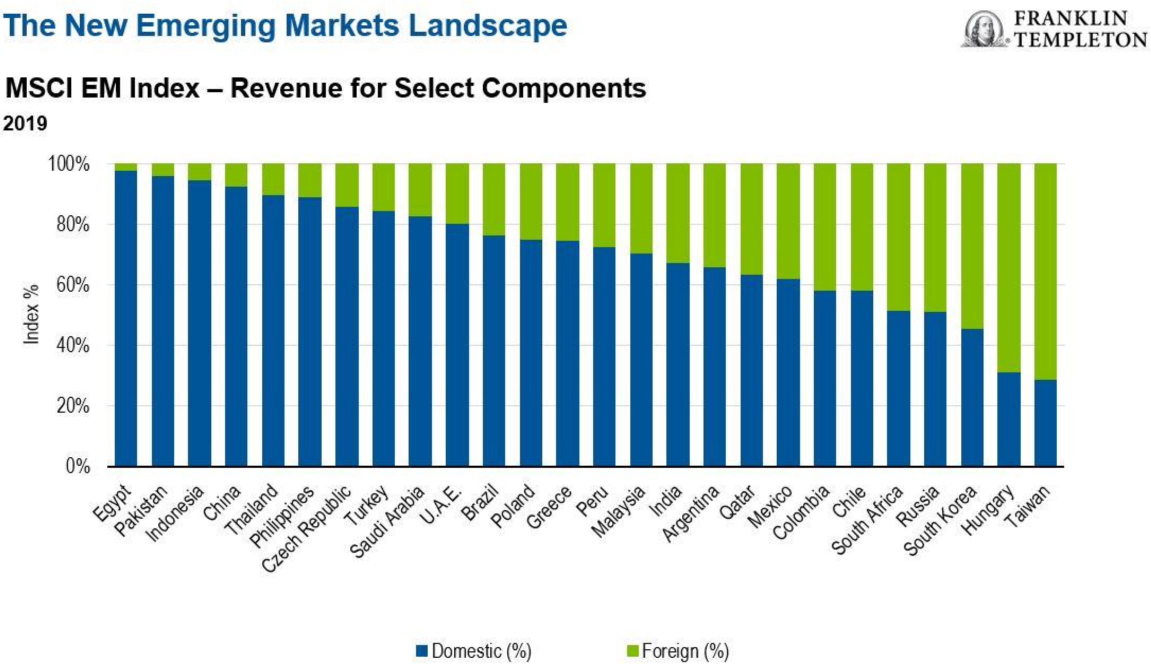
It will be interesting to note how the blame game plays out, with Trump pushing hard to deflect attention away from the weaker economy. Australia has been vocal in calling for a review of China's role in the COVID-19 outbreak, but then had tariffs of 80% placed on imported barley. With China involved in high proportions of the supply chain, countries will find it difficult to do much without significant repercussions.

The virus has spread within Latin America and particularly Brazil. In times of market stress Emerging Markets tend to get hit the hardest and according to Somerset Capital Management, $80 billion of funds has been withdrawn. This is three times the levels seen in 2008. Emerging markets are at their cheapest, relative to the US, since 2001.

Interestingly from the data supplied by McKinsey it shows several Emerging Market economies with higher levels of optimism, including Indonesia, Nigeria, China, the Dominican Republic, and Saudi Arabia, with a net increase in expected spending in the next few weeks. These levels of optimism have not reached the developed world just yet.

In many economies the fundamentals of Emerging Markets are stronger than their Western counterparties. Emerging economies have been through a transformation. While many investors once considered emerging markets a commodity trade, the asset class has become widely diversified. Today, rising domestic consumption and technology are greater drivers of economic growth for many emerging countries than commodity exports.

In the past, emerging market economies were broadly reliant on cheap exports of natural resources to developed markets. Today, they benefit from both internal and external growth drivers. The table below from Templeton expands on this.



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Many emerging markets are primarily domestically driven, including large economies such as China and Brazil. A significant portion of exports are also intra-emerging market trades, versus exporting to developed markets. This is an important factor to consider when considering the trade wars.

For example, China has been re-balancing its economy for many years; domestic consumption is now the key driver of economic growth, representing 76% of gross domestic product in 2018, up from 44% a decade ago.

There is a growing middle class which has increased consumption of high-quality goods and services. COVID-19 could dampen discretionary spending in the short term, but the secular factors such as favourable demographics, rising income and urbanization remain very much intact.

It is highly likely emerging economies could also eventually come out of the current crisis stronger, as new technologies are adopted during the crisis and remain vital after.

There is evidence of the emerging-market share of global, high value-add exports has risen dramatically since the start of the 21st century, with China and South Korea as leading examples.

Emerging markets, which initially found economic success in producing low-value goods, have now set their sights further up the value chain. Many emerging markets today are established players and integral to global supply chains, given competitive labour costs and continued investments in research and development. Samsung Electronics, which evolved into the world's largest memory chip maker, is just one example.

In summary, some will be challenged but there will be many that will come out of this strong. Several of the economies are more domestic driven, and although in the short term this might slow, the long-term story remains positive. Equally although China/US trade is a concern, ultimately many of these economies rely less and less on the West as trade partners but trade between other EM economies.

CASH

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In the last update we indicated that interest rates might start to rise, but we were not expecting a global pandemic, they have now dropped to near zero. Interest rates will only rise when QE stops and there are steps to unwind this, but it is not going to happen anytime soon.

With inflation we will see a continued erosion of purchasing power of large sums held in cash. There are good reasons to hold an 'emergency fund' for liquidity and short-term requirements, but it is less and less suitable for long term investment of sizeable amounts. It is likely that those on the side-lines with cash will eventually return to the markets as they hunt for better returns and income options.

Additionally, yields on investment grade bonds are likely to reduce, unless investors are prepared to take additional risk by using bonds with lower credit ratings and a higher risk of default, and/or the potential to lose money.

In summary, cash investments will remain challenged for some time yet.

CONCLUSION

There has been much debate, with many people, on the type of recovery. It will come but will not be straightforward. History shows that economies improve, and markets turn before the end of the recession. The case for timing the market as an unwise strategy is as strong as ever.

The speed of the decline and the recovery surprised many. Some fund managers saw opportunities but waited for lower entry points meaning that they missed the window by waiting even 24 hours. This highlights the risks of trying to time entry and exit.

Many believe markets have reached their low points. We do not know whether markets will return to those levels again, but it should be said that investors withdrawing money at the lowest point will find it hard to find the optimum re-entry point.

It is important to stress that there is a long road to recovery, whether we see this in 2021 or 2022 and there will be bumps along the way. JP Morgan talk about a stop/start recovery driven by factors like the effect of social distancing and its drag on key employment sectors, unemployment scars (the life-long impact of unemployment), corporate debt and political risks. Tourism is likely to take the longest to recover fully – if that is possible.

We are monitoring key areas such as a second wave, vaccine/treatments, China vs US, the US election and Brexit. Markets and economies do recover, albeit the speed of recovery in markets is quicker than in economies. However, when people see the economy returning to normal and they want to invest, they have often missed the best entry points.

A low interest rate environment, low inflation QE, the hunt for income driving up prices and a wall of cash waiting to be invested are all good for investments in the long-term.

In the short-term, we should be aware that markets will struggle with contradictory news. Recently the Bank of England announced more QE but at the same time said they would be slowing the programme. Additionally, if the US decided to extend the period for unemployment payments but reduced the amount from $600 to $200, this could prove negative and add to volatility over the next 6 to 12 months.

We cannot guess the performance of markets by the end of the year, but we feel confident signs are good long-term for equity markets. There will likely be rallies across different sectors, but quality companies and strong balance sheets are potential winners over the long-term, which helps increase market share. Those companies building greater debt in what is likely to be a lower growth environment are likely to struggle and may not survive.

Source: Charts have been sourced from Morningstar. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.