Coronavirus Commentary

23rd June 2020

Market Commentary and Strategy

Within this update, we have summarised our current investment strategy in the context of various identified risks and opportunities, including those discussed within the commentaries during the Covid-19 global pandemic.

<u>**Overweight Equities and Underweight Bonds**</u>

We have positioned our investment strategies to have increased weighting to equity markets with corresponding reductions within fixed interest holdings. The Margetts Providence fund, for example, has a neutral allocation between equities and fixed interest of 50/50 and is currently positioned at 56/44 in favour of equities.

During equity market falls in February and March, which occurred as the Covid-19 pandemic spread to Western economies, we increased purchases of equities at increasingly attractive prices to maintain our target exposure. More recently, we have reversed this process during the sharp recovery to take profits as momentum reversed, while maintaining the overall strategy stated above.

The key arguments in favour of this position are:

- Covid-19 risks are <u>overestimated</u> by global stock markets
- Equities are attractively priced in many markets
- Fixed interest markets offer unattractive, below inflation yields

Covid-19 risks are overestimated by global stock markets

Covid-19 has led to a sequential shutdown of Asia, Europe and the US since March in order to protect healthcare systems from overload and reduce fatalities within vulnerable categories, typically older people or those with existing conditions.

These shutdowns have caused a dramatic fall in economic output, but this has been countered by an enormous global stimulus package of approximately $10 trillion to date, representing three times the entire stimulus applied following the credit crisis, released eight times more quickly, and including direct payments to people and companies. It is difficult to overstate the magnitude of the combined global stimulus packages.

The evidence from China and South Korea particularly have demonstrated that the spread of the virus can be controlled and have recorded a 'V' shaped recovery in confidence following the removal or relaxation of economic restrictions. We expect Europe to follow a similar path, although the US may struggle to do so for reasons discussed later within this document.

Throughout the Covid-19 pandemic, the global economy has been developing management strategies, treatments and cures to reduce the risks posed by the virus. This work has led to social distancing measures, temperature taking, testing, phone apps, drug development and over 120 potential vaccines in development, amongst other developments. This learning curve has already reduced the risks posed and is expected to continue to do so, perhaps with the pace of development increasing further given the resources being deployed.

The deep recessions currently being experienced within economies are a result of supply being forced to close rather than a decrease in demand, which is a more typical cause of recessions. Although unequal, the stimulus applied has maintained demand during this period and we expect it to rise rapidly once supply can be re-instated through economic lockdown easing. There is growing evidence of this from Asia and early signs in Europe.

So far, 25 economies with Covid-19 infections have become virus free, with a further 50 recording less than 100 active cases, although these are generally smaller countries. New stories have circulated about further outbreaks in China and South Korea, but these have been successfully controlled.

Extended first waves have been seen in Iran, some US states, India, Mexico and Pakistan, which are a cause for concern as lockdown measures have either not been used or enforced properly, or restrictions have been lifted too soon. These areas represent an understandable source of anxiety. However, should infections continue to rise, we do not expect a full economic lockdown to be deployed, except in a temporary instance to protect overwhelmed health facilities.

Further full lock downs are unlikely due to the difficulties in obtaining public consent, the guaranteed economic harm, and the failure to be effective in the first instance likely to be repeated. As economies preparedness for Covid-19 social distancing has increased, the need and benefit of lockdowns has reduced.

The OECD have published their projection for a ‘V’ shaped economic recovery if secondary economic lockdowns are avoided, and currently they have placed a high probability on this outcome.

Equity Markets Valuations are generally attractive

The relationship between dividend yields and the cost of debt is a useful way to consider the valuation of an equity market. If an investor can reasonably expect the dividend stream to service a loan, there are prospects for values to rise as investors can borrow to invest in much the same way as a buy-to-let property may be financed by a mortgage.

Following the credit crisis and the recent Covid-19 stimulus, interest rates have fallen to near zero levels, and therefore debt is historically cheap. Amazon, as an example, recently borrowed over 3 years for around 0.40% per annum. By contrast the yield on UK equities is around 5%, even accounting for the various cancelled, reduced, or postponed dividends announced during the recent crisis. The current differential is historically high and driven by Covid-19 anxiety together with Brexit considerations. As fears begin to diminish, there are strong prospects for capital growth together with future dividends.

Although the UK is particularly good value, other markets with significant differentials include Asia and Europe. US dividends are generally above the cost of debt but only marginally due to the higher valuation of the US market and recent strong relative performance.

Economies’ ability to manage Covid-19 is expected to reflect in short term performance

Although we do not expect further full-scale economic lockdowns, the impact on economies will be materially affected by Covid-19 control measures. Those economies which quash the virus most effectively will have fewer control measures, resulting in a faster return to near-normal levels of output.

Asia and Europe, by and large, show signs of having reduced transmission, and are now reversing many of their economically debilitating control measures. The US has not been able to achieve the same position, imposing controls late and lifting them relatively early, leading to a further increase in cases. This is expected to slow the recovery of the US economy when compared to Asia and Europe.

Southern America and other emerging markets are further behind in the cycle and also seeing continued increases in the number of daily infections. These markets have the advantage of younger-leaning demographics and are showing a lower proportion of fatalities at present. These markets could become very attractive if they achieve 'herd immunity', but the position is too uncertain at present.

In the short term, we expect Asian and European markets to outperform US indices due to their lower valuations and greater success in dealing with Covid-19.

Fixed interest markets offer poor value

The performance of bond markets in recent years has been difficult to explain from a rational investment perspective. Investors generally seek returns ahead of expected inflation so that their purchasing power increases over time.

Prior to the credit crisis, government bond markets generally offered returns ahead of inflation. However, central banks became heavily involved in bond market manipulation through their own purchases and forward interest rate guidance. This has been repeated and accelerated as part of Covid-19 stimulus packages to the point where, for example, 20-year government debt yields around 0.5%, even while the Bank of England maintains a long-term inflation target of 2.0%. The prospect of sub-inflationary returns, with the additional potential downside that medium term inflation may rise ahead of target due the stimulus applied, causes fixed interest assets to be deeply unattractive at present.

Therefore, we hold reduced allocations to this asset class and have selected assets with short maturities and high credit ratings offering returns at or above the target level of inflation, i.e. 2%.

Underweight the US market

Within our general overweight allocation to equities, we hold a reduced allocation to the US which is the largest global market by capitalisation.

The Margetts International fund, for example, has a benchmark weighting of 50% and currently holds a 30% allocation to this area.

The dominance of the US stock market has been remarkable in recent years. In rough numbers, Europe, Asia and UK stock markets have returned around 50-60% over the past decade whilst the US has returned 150% in dollar terms.

The election of Donald Trump in 2016 encouraged markets due to his pro-business stance. His re-election in November is questionable following falling ratings due to apparent poor management of Covid-19, several scandals, and bizarre behaviour during his presidency. His opponent, Joe Biden, would present a less business friendly approach in the event of his election and could take the edge off market expectations.

Within this market, there have been a small number of dominant stocks, with 5 stocks (Amazon, Facebook, Apple, Alphabet and Microsoft) now comprising over 20% of the S&P 500 in terms of market capitalisation.

The level of distortion hints at future risks and is reminiscent of the FTSE 100 in 1999 where Vodafone peaked at 12% of the index. The subsequent fall in the index value was not connected to economic growth which continued to be stable from 2000 up to the credit crisis in 2009.

Although these stocks appear to have an unassailable advantage at present, history shows that the largest stocks within the S&P 500 cycle frequently change. In 2013 ExxonMobil and GE were top 5 members, in 2005 Citigroup was in fourth place, Pfizer and Cisco were both members in 2000 and in 1995 none of the current five were included in the line-up which consisted of GE, AT&T, Exxon, Coca-Cola and Merck.

Whilst we expect the US economy to recover and US stocks to make gains, we anticipate higher returns from other global equity markets due to more attractive relative valuations and shorter-term Covid-19 factors mentioned previously.

Summary

We are positioned to benefit if equities rise in value, and particularly if undervalued markets such as the UK and Asia move closer to US valuations.

Our fixed interest positioning is defensive and expected to provide small positive returns in most scenarios. Major indices could lose value if the economic mood becomes more optimistic, medium term inflation expectations rise, or central banks reduce their purchases of assets. One or several of these outcomes is considered likely.

Important Information

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Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested especially in the early years.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

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