Coronavirus Commentary

30th June 2020

Market Commentary and Strategy

Within our last update, we 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. This week we are updating those thoughts based on further developments last week.

Overweight Equities and Underweight Bonds

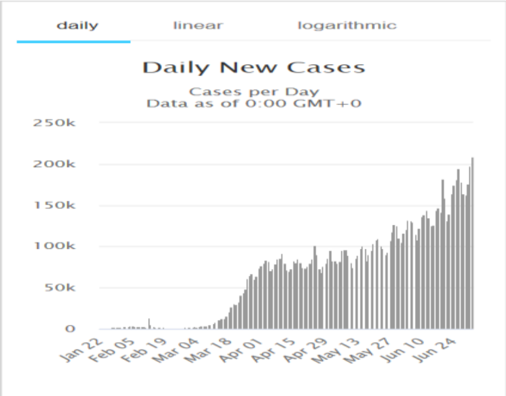
This week the Bank of England's chief economist, Andy Haldane, said the UK economy was recovering much faster than expected and he had voted against pumping another £100bn of printed money into the economy. Although in a singular minority, he believed current data indicated that the economy would recover to be 3% larger than expected, pushing inflation expectations up by 1%.

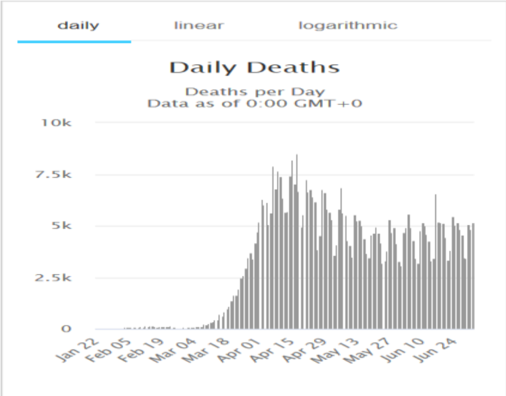
Longer dated Gilts dipped following this news and Mr Haldane's views coincide with our concerns that the level of stimulus being applied globally is likely to lead to medium term inflationary increases. With yields already well below the current Bank of England inflationary target, a rise in inflation would further reduce the case for this asset class.

Covid-19 risks are overestimated by global stock market

Covid-19 cases have continued to rise globally with a new daily record set of 57,236 cases in the US on 2nd July 2020 and further records expected over the next few days and possibly weeks. Cases also continue to rise in key emerging markets such as Brazil, India and Pakistan, adding to the daily total which has exceeded 200,000 for the first time.

Although worrying, markets have not reacted negatively to this surge in cases, as it has not been accompanied by the same surge in fatalities observed in March/April. The graphs below show the daily cases and the daily deaths on a global basis.





The factors likely to have broken down the relationship between cases and deaths are:

- The increase in testing globally is now identifying more cases, especially where symptoms are mild, that would not have been identified in March/April.

- The treatment methods have improved with existing drugs identified to help reduce symptoms leading to fewer fatalities.

- New infection hotspots have emerged in countries with lower age demographics. Covid-19 is much more likely to be fatal in older communities such as northern Italy, rather than younger populations.

- There are unconfirmed but creditable accounts from Italian scientists that Covid-19 is mutating into a less virulent virus, and therefore the fatality rate is reducing.

The main risk to equity markets is a second economic shutdown which, according to the OECD, would lead to a 'W' shaped recovery. We do not expect this to occur as the problem of re-opening will present itself once more. Instead, economies with higher transmission of Covid-19 will impose stricter social distancing measures and experience slowing economic output, but not the closing of the economy altogether. Full closures are only expected if health care systems become overwhelmed and, even then, on a very temporary basis.

Those markets which have effectively controlled Covid-19 are expected to have an advantage and their domestic markets will be more attractive to investors. Evidence of this is being seen in key Asian economies, where markets have been buoyant, as further Covid-19 outbreaks have been successfully managed and slowed. The same trend is expected in the UK and Europe, but not the US, as it struggles to get Covid-19 infections under control.

Quite a few vaccine trials in both the UK, China and US have begun human trials and reported success in creating effective Covid-19 antibodies. With all three leading manufacturers, and around 120 in total, reporting the ability to produce millions of doses by the end of 2020, the risks from Covid-19 could be largely mitigated by Christmas.

Diversification of style is important

Investors often think of investment styles as being either 'growth' or 'value'. Growth companies are developing businesses which can look expensive on current turnover but are expected to grow significantly, while value stocks tend to be mature businesses with a high level of predictability.

In recent years, largely since 2015, growth stocks have materially outperformed their value counterparts with the S&P 500 now dominated by 5 stocks (Microsoft, Apple, Amazon, Alphabet and Facebook) which make up over 20% of the index.

The recent collapse of Wirecard, a fintech growth stock, is a reminder that investors can get carried away with an idea and be distracted from reality. Although allegations of fraud were published by the FT in early 2019, investors continued to support Wirecard until its collapse last week when $2bn could not be found.

We feel Tesla is another stock where exuberance has overtaken fundamental analysis. This company has posted a small profit for one quarter, but this week became the most valuable car manufacturer in the world. Demand for the older, more profitable models 'S' and 'Y' are falling while the new Model 3 is enjoying better than forecast sales. With more established manufacturers bringing their own electric models to the market, the first mover advantage enjoyed by Tesla is not going to last and the share price looks hard to justify.

History shows that growth and value styles enjoy waves of popularity and investors currently focusing on short term performance are likely to be drawn to growth styles at present. One key moment in history was the rise of technology stocks in the 1990s, following which value stocks went on to provide positive returns while growth stocks fell during a period of sustained economic growth. To avoid this risk, we are maintaining a balance of both styles due to concerns of some 'fluffy' valuations within growth stocks and the possibility of a reversal within attractively priced value stocks.

Brexit

Both sterling and UK stocks have been diminished in value, relative to other global markets, following the uncertainty caused by the Brexit referendum on 23 June 2016. During this time, we have maintained the position that a soft Brexit with a trade deal was the likely outcome and we remain of this opinion.

The perceived risks of Brexit are now lower due to the increased global risks from Covid-19. In addition, the tone of the negotiations seems to have improved, with the EU giving some ground on the thorny issues of fisheries and the role of the European courts. The 'fake' deadline to extend the transition period of 30th June has passed, although both sides could agree to anything at anytime in reality. Nevertheless, we expect the UK government to be firm on the 31st December 2020 deadline, but the likelihood of a deal appears to be rising slowly, benefitting both sterling and UK assets more generally.

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, whilst 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.

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