Margetts Quarterly Commentary

30 April 2020 – 31 July 2020

The repercussions of Covid-19 have continued to dominate markets throughout this reporting period. Equity markets which fell sharply in the previous quarter, rebounded strongly in this quarter, despite economic data deteriorating rapidly as official figures reflected the impact of economic lockdowns across the world. Just as equity markets fell in anticipation of the economic impact from Covid-19, investors now appear to be pricing in a rapid 'V' shaped recovery later this year and into 2021.

Over the period, based on the Investment Association sectors, the notable performances came from Global Emerging Markets +12.73%, Europe Ex UK +12.57%, Asia Pacific Ex Japan +11.22% and North America +7.98%. UK Gilts returned, a nearly flat, 0.4% whilst UK All companies only rose by 1.17% in value.

The widespread economic lockdowns applied to control the spread of Covid-19 have been remarkable. Under normal circumstances this action would have triggered a collapse in economic output and global stock markets. However, the potential temporary nature of the lockdown, coupled with an extraordinary level of stimulus, has created the metaphorical equivalent of putting your head in the freezer and feet in the oven so being, on average, at the right temperature, but very uncomfortable. Some markets, such as the UK, remain well below previous highs whereas others, like the tech orientated NASDAQ have reached new highs.

Investors could be forgiven for scratching their heads and wondering what will happen next. There are several puzzling trends, for example the rapid rise in the price of gold indicates inflationary pressures are increasing, perhaps due to the fiscal stimulus applied, while record low long-term government bond yields suggest the opposite. Banks have been making big provisions for bad debts, pointing to a deep recession, whilst technology stocks have risen indicating strong earnings growth will continue. Meanwhile, airline stocks have become little more than a bet that an effective Covid-19 vaccine will be deployed within the next six months.

It feels as through the global economy has become a 'Covid Casino' due to the high level of uncertainty that presently exists, especially in the short term. Although challenging, we believe we have been able to develop a cohesive investment strategy, based on detailed observations and carefully considered expectations, as set out below.

Covid-19 infections have been controlled in many economies including China, South Korea, Italy, Portugal, UK, Sweden and many more. A further increase in infections has been recorded in the US and Spain with new outbreaks in India and South America. Although detected infections have risen significantly above the initial peak in March, deaths have remained below peak levels, indicating that the initial global wave of infections is continuing to mature.

Although economic shutdowns have been financially damaging, the fiscal stimulus to date exceeds 15% of global GDP at approximately $10 trillion and continuing to rise. The size of the stimulus is difficult to exaggerate being 3 times larger than the stimulus applied in response to the credit crisis actioned eight times more quickly and has offset a large proportion of the economic damage inflicted to date.

The learning curve in response to Covid-19 is steep with economies ramping up social distancing policies, testing and treatments to the point where economies can reach around 90% of output and rising, whilst managing Covid-19 risks. The prospect of a successful vaccine is likely, although not certain, with several potential drugs in final trials having reported encouraging earlier results. A successful vaccine would boost equity markets whilst downside risks appear to be subsiding as conventional management strategies evolve limiting further economic pain. Russia recently announced they would be beginning their vaccine programme in October with the UK leading the western world response, looking to deploy a vaccine before the end of the year.

We are holding an overweight allocation to equities as we believe downside risks are lower, and falling, while upside prospects are attractive and supported by on-going stimulus.

Much of the stimulus applied to the global economy has resulted in the borrowing requirements of governments increasing to record levels. Ordinarily, the cost of borrowing increases as more borrowing is required, however the response to the 2008/9 credit crisis created a downward spiral in the cost of debt which has been further exacerbated by Covid-19 fiscal measures.

The general rule that government should not borrow more than 40% of GDP applied when it was also expected that yields would exceed inflation. The current cost for the UK government to borrow over 30 years is only 0.66% per annum, around 20 times lower than the cost at the end of 1980s which was the last time the 40% target was met. The problem with high borrowing is that high or rising debt servicing costs begin to strangle growth. With yields below inflation, the rules seem to have changed and the current level of 100% debt to GDP does not present the same risk, at least not for the borrower.

To illustrate this point, take the current position of debt to GDP of 100% in the UK and imagine economic growth is zero whilst inflation meets the long-term target of 2%. Due to the effect of compounding, described by Einstein as the 8th wonder of the world, debt is re-paid by inflation and reduces to 67.25% of GDP over 30 years. Imagine inflation is closer to 3%, as we expect due to the effect of the various stimulus measures and GDP grows at 1%, the debt is reduced to only 38% of GDP over 30 years.

Inflation is a significant factor which markets could be under-pricing. We have discussed that the surging gold price is signalling higher future inflation and there is evidence to support this. The inflationary effects of post credit crisis measures were surprisingly limited given the level of money created by central banks and pushed into the economy. At the time, central banks were careful to move money in global bond markets to avoid direct spending to reduce inflation risk. This time the approach appears more complacent with cash injected more quickly and directly to people and businesses, creating a hard transmission route into the economy, increasing inflation risk.

The risk within debt markets has transferred from the borrower to the lender due to the sub-inflation yield, and so we are holding reduced exposure to this asset class and focussing on short term, high quality debt providing returns ahead of inflation.

Although equity markets appear to have provided strong returns over the past decade, since 2015 the returns are being driven by the US markets and particularly higher growth, technology and/or innovation businesses. Over the past 5 years there has been a significant divergence between old economy stocks and new economy stocks with 5 companies (Apple, Alphabet, Amazon, Facebook and Microsoft) now representing 20% by value of the S&P 500 which in turn represents around 55% of equity markets globally.

Covid-19 has provided a further surge to this dramatic existing trend as businesses have been forced to embrace 5 years of technology behavioural change in five weeks to meet social distancing requirements. Investors have been keen to buy stocks which have increased earnings despite valuations becoming expensive. Tesla is perhaps the best example of a stock price surge as its share price has increased fourfold since the end of 2019.

Whilst history does not repeat itself, it does often rhyme and there are clear similarities to the late 1990s. During this period technology stocks surged well beyond their fair value as future expectations were very high. For example, in the UK Vodafone became 12% of the FTSE 100 index before falling dramatically in value.

This time around businesses are much stronger with very significant earnings, but with regulation on the horizon and the potential drop in on-line demand if Covid-19 abates, there is a risk that these stocks are now overcrowded especially with passive funds adopting the concentration levels of the index.

In the early 2000s technology stocks led major indices down significantly and this bear market was particularly unusual as economic growth remained positive. The experience of the recent Wirecard collapse suggests investors may be getting carried away as this stock price was buoyant despite press warnings of massive misappropriation of funds. The stock only collapsed when the firm admitted around $2bn of missing assets. Were investors blinded to reality by the popular Fintech nature of the stock and could this be happening elsewhere?

With much of the market and index trackers now biased towards growth stock, we are maintaining a broader growth/value balance due to the possibility of a potentially dramatic trend reversal. On this occasion, the risk of a tech crash seems low but a melt-up of attractively valued, out of favour, old economy stocks is possible and would favour markets such as the UK and Europe, which have fewer growth stock listings.

The approaches taken by companies during the Q2 reporting season have differed widely. Contrasted with growth companies keen to squeeze out profit to show their strength in the face of adversity, businesses clearly affected by Covid-19 have opted to show the pain in full with banks, for example, dramatically increasing their bad loan reserves and lowering future forecasts. We suspect that companies able to blame Covid-19 for problems will be tempted to lower expectations based on this external threat to provide the best prospects for recovery, which management can attribute to their stewardship later. In effect, Covid-19 affected companies might be compressing their potential, providing the opportunity for upside surprises in the future.

As we move through August the Brexit deadline of 31 December 2020 is coming into sight and we expect Boris Johnson to honour his promise that the deadline will not be extended. After four years of uncertainty, the question of our future relationship will finally be answered. Surprisingly, news flow has been light, in contrast to the regular hostile press leaks from both side during the negotiation of the withdrawal agreement. We suspect that no news could be good news and remain optimistic that a deal will be reached as this appears in the interests of both parties, especially given the additional risks to trade presented by Covid-19. If a no-deal outcome emerges, the downside risks have reduced as Covid-19 risks and stimulatory global response have 'trumped' the relative pain to the UK economy.

Following the trend of other countries which have emerged from Covid-19, the UK recently posted strong figures showing that manufacturing in the UK has returned to growth. We also expect to see strong spending for Q3 as many families have been forced, or chosen, to take holidays at home. Considering the current attractive UK equity valuations, the possibility of a Covid-19 recovery, strong consumer spending and possible Brexit outcome, the UK stock market offers attractive upside potential in our view.

The encouraging outlook for the UK is also matched with an improving position for European markets. The EU reached a historic agreement in recent weeks to provide a 750 bn Euro bailout fund. The EU failed to act swiftly following the credit crisis in 2008/09 and became dogged with wealthier members refusing to bailout countries such as Greece and Portugal. When agreement came it was years too late and too little, leading to a slower than optimal recovery in the European economy. Although tense, the negotiation and response to Covid-19 has been far quicker and led to a boost in confidence for equities and the EU.

The strength of the US economy in the recent cycle was born from their quick and effective response to the 2008/9 credit crisis taking a 'first out of the block' advantage that has been maintained and developed further. The tables have turned with Covid-19 as Asia and Europe seem to have recovered more effectively than the US, which went backwards in terms of Covid-19 infections and is now seeing a slower economic recovery. We see evidence that the long term outperformance of US markets could reverse going forward and this is further compounded by the odds rising that Donald Trump will be replaced by the less business friendly Joe Biden.

Strategy

As detailed above, we have an overweight position in equities with a high level of diversification between growth and value stocks.

Fixed interest positions are generally tilted towards shorter dated, high quality bonds avoiding both perceived inflation and interest rate risks.

Geographically we are below benchmark weightings in the US market in favour of the UK and Asia, while being neutral on Europe.