Your Questions Answered

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Tom Becket, Chief Investment Officer, answers some commonly asked questions about the impact of the coronavirus on financial markets and the wider economy. The questions below were raised during our new weekly webinars and come directly from our advisers and clients.

Have the chances of our forward-looking scenarios changed?

Our "base" case scenario that we outlined in a View a month ago has not changed materially, although we have to recognise that the path we initially outlined of one month of total economic shutdown, followed by a month of partial recovery, leading to a month of further recovery before a return to full economic power by the autumn will need to be pushed back.

The governments of Europe have pursued longer periods of "full" shutdown than we previously anticipated and it now appears that the reopening of respective economies will be slower than we hoped. In the case of the US, we are far from clear about how the economy will reopen and what the differentiated approaches between states will lead to, as the US more broadly starts to emerge from the initial phase of this crisis. In addition, it has become increasingly clear that our daily lives will not get back to "normal" for longer than anyone expected, based upon the preliminary signs we are seeing from the UK government, the noises coming from various European authorities, and the early experience of those economies that have reopened in Asia.

It is questionable whether we can take the positive news of a suggested rapid return to normal in China as a fair guide as to how a country fares post lockdown, due to the doubtful veracity of the news that comes from the country; most indicators point towards the Chinese economy recovering back to levels of around 75% of 2019 output. However, it is notable that Singapore is once again dealing with a rise in infections and has entered a period of further lockdown, which is similar to the experience of Japan. At this point in time the experiences of the economies emerging first from lockdown present more questions than they do answers.

Given that we cannot forecast how individual governments, including our own, will deal with future rises in COVID-19 infections, it is very hard to be precise about the economic path ahead, but we would certainly still consider the "protracted U" shaped recovery as much more likely than either the more optimistic "V" shaped recovery or the more worrying prospect of an "L" shaped, where economic growth fails to respond to the mighty stimulus applied by governments and central banks around the world and the behaviour of consumers and companies are changed permanently.

Do we have any indications of current economic conditions?

All recent evidence suggests that the current state of the global economy is extremely concerning, with the sharpest drop in economic activity and the severest recession since the end of World War Two. This is also a uniquely bad period for the global economy, as this crisis has engulfed every part of the world, rather than being a more usual regionalised drop in economic growth. However, as bad as the global economy is, we should have expected this sharp contraction in economic activity to be the case, given the decisions taken to close the economy worldwide.

It would be easy, but unnecessary, to rattle off negative data point after negative data point to show how historically bad the economy currently is, but one piece of news flow that should serve to show the challenges of the current situation comes from the US, where 26.5 million unfortunate workers have lost their jobs in 5 weeks; this is out of a total pre-COVID-19 workforce of 160 million people. The recent job losses have eradicated all job gains enjoyed in the US since the end of the Great Financial Crisis in 2009.

Our current forecasts, based upon our "U" shaped recession scenario, show total global economic growth contracting by c3% (in real terms) this year, which is c5.5% below what we perceive to be "trend growth" of c2.5% per annum. There will be a strong recovery starting in the second half of 2020 and continuing into next year, with some pent-up demand coming through and governments supporting the recovery, but our forecasts assume that a sizeable portion of the "lost growth" from this year will now never come through. The overarching question that we need to ask ourselves is whether the experience of this ongoing crisis will permanently impair long term growth rates, as is typical after many recessions. This is a subject we will return to in a future View, but we absolutely expect there to be changes to our lives after this crisis is resolved that will skew the future path of the global economy. These changes in our daily lives will also lead to both success stories and failures amongst global investments, meaning that a highly selective approach to investing will be vital in the coming years.

Are diagnostic testing and a widely used vaccine key to a "return to normal"?

We view diagnostic testing as a vital factor in reopening the economies in Western Europe and the US. Unfortunately, there is not a uniform approach across those countries, and some are ahead of others in terms of both their completed tests and testing capabilities. The UK appears to be one of the laggards in this process. It is only when mass testing is being conducted that we can envisage a resumption of the daily practices that we enjoyed before the virus emerged. We would expect that, when diagnostic testing is more widespread, that there will be a phased return to work, with most of us not returning to offices before mid-summer, at the earliest, and with major restrictions still in place for some time to come.

The eventual delivery of a vaccine is the key to a more complete return to normal and our understanding is that it should be feasible to mass-produce a vaccine around the start of 2021 (there are obviously risks to this forecast). Hopefully with the brightest scientists and specialists around the world working on this at the same time, this is realistic prospect and timeframe, not least given the logistical efforts that will be made to make this hope a reality.

Why are equity markets recovering so strongly, despite the grave economic situation?

There are, as always, several different factors to take into consideration when assessing the performance of equity markets. The easiest answer is that they are now clearly discounting a rapid return to "normal" after economies start to reopen. Our assessment is that such a view is excessively optimistic and premature. We have far greater sympathy with the argument that investors are trying to look through the current economic turmoil and position themselves for the economic recovery and a return to normal in the coming years. Even taking this view, we are surprised by the speed of the recent recovery in equity markets, with the US S&P 500 registering its biggest monthly rise since 1974.

However, the answer given so far is too simple, as there is also the key factor of the helping hand of central bankers behind markets' recent recovery. There will be some who brush aside this factor as "unimportant", but with interest rates now anchored near 0% and likely to be there for many years to come, as well as the ferocious pumping of money into financial markets by central bankers, we must recognise that the "game" has changed. At this point in time, it has become clear that it is the desperate search for sustainable income in a zero interest-rate world, as well as an increasingly entrenched belief that one shouldn't fight the central bankers' liquidity injections, that is contributing towards risk appetite and leading to expensive valuations.

Extreme skews are now becoming inescapably obvious, with investors all clamouring after a few concentrated investment themes. One such favoured investment is technology, where the perception is that the sector is "virus proof" and will continue to grow regardless of what might happen in the global economy.

Again, we have some sympathy with this view and own investments that should be major beneficiaries of the changes in our personal and professional practices once the threat of the virus recedes.

Another obsessive theme for investors is "growth in a low growth" world, with a frenzied buying of any "dependable" growth companies barely taking a pause despite the deep recession in the global economy; it is also such investments that have enjoyed recent inflows in the markets' recovery in April.

It is worth noting that our investments most closely linked to technology and other growth themes are in positive territory this year, which is remarkable given we are suffering the worst economic period in 75 years. American and, by implication due to American companies' omnipotent size, global equity indices have become ever more dominated by technology and growth companies (normally a worrying sign of market performance to come), and valuations of US equities have now surpassed the rich levels seen at the time of the peak of the US equity market earlier this year and are at the highest level that they have been since the bursting of the tech bubble of the early days of this century.

Any break in the recent positive performance of the tech and growth themes would be a hammer blow to investors, who are almost uniformly fanatically keen holders of such investments, which is one of the key reasons that the US Federal Reserve is printing money so aggressively to keep markets rising and valuations levitating at historically high levels. This could of course continue, and we must concede that, in spite of some doubts over the sustainability of equity markets' recent improvement, it is entirely possible that we see US equity markets hitting new highs in the middle of a savage global economic recession, which is an extraordinary indication of the distorted world that we now live in.

Why has the UK market underperformed again this year? Couldn't the value equity theme continue to disappoint, whilst growth companies continue to rise?

It is both somewhat ironic and majorly disappointing that just as we start to get some clarity on the "Brexit" situation and the promise of political stability in the UK in late 2019, the world suffers a global virus pandemic that is particularly bad for the UK equity market. At the end of last year, UK equities had started to once again come in to favour for international investors, but this improvement in sentiment came to a screeching halt as the COVID-19 crisis emerged.

The UK's underperformance relative to global equity markets this year is not down to the UK government's own handling of the COVID-19 crisis or a perfect reflection of relative prospects of the UK economy, but demonstrates the fact that the UK equity index has heavy sectoral biases towards global resources companies and both UK and international banks. These sectors have performed poorly this year, particularly by comparison to the seemingly impervious tech sector (which is scarcely represented in the UK equity index), as investors have taken fright at the sharp falls in commodity prices and worried that the global recession will lead to rapidly rising levels of non-performing loans at banks. These are understandable reactions in the context of slumping economic growth and an oil price war between major producing oil nations, which even led to the oil price trading at a negative price on an extraordinary day in mid-April.

However, as we cast our nets around the world and look for attractively valued opportunities, we can find plenty of reasons to like certain UK and "value" assets. As "dependable growth" themes have become increasingly en vogue, there has been an indiscriminate selling of any assets that are exposed to the cyclical parts of the global economy, and this has created pockets of outstanding value for investors.

We consider ourselves to be "contrarian" investors and we have tried to identify opportunities that other investors are ignoring, in order to take advantage of long-term price discrepancies. Backing either the "growth" or "value" theme entirely at this time would be irresponsible, given the wide range of future outcomes for both the global economy and financial markets, and this is reflected in our current equity allocations that are a "barbell" between growth themes and long-term value opportunities that are out of favour.

What are the chances of defaults in our fixed income and credit selections?

By far the best medium opportunities we can identify are in both corporate and consumer credit instruments. While March was one of the most uncomfortable months ever for investors in fixed income instruments, the brutal sell-off has, in our view, created some of the best value opportunities bond investors are likely to see for several years. Credit nearly always leads a recovery and the double-digit yields are rare (particularly in the 0% interest rate world we live in) and worth taking advantage of. Fixed income investors have witnessed what will likely go down as a once-in-a-decade repricing of risk. While we are far from seeing the other side of the COVID-19 crisis or the economic downturn, we may well look back at this period of 2020 as the best opportunity this decade for fixed income credit markets. The chances are that these opportunities will disappear relatively quickly, as the desperate hunt for yield continues and the world emerges from the current crisis that we are in.

However, high yields clearly signify that there are elevated risks of default in global credit markets. For this reason, we continue to be very selective and we have almost no exposure to the problematic sectors, such as energy, travel and leisure. There will undoubtedly be a high number of defaults in those sectors to come. The COVID-19 situation completely changed the economic path for the global economy and, while we expected a major hit to corporate profitability and positioned our portfolios to reflect this view, we did not envisage the actions the governments of the world would be forced to take and the stress that would put on corporate balance sheets and consumers' creditworthiness. This unexpected situation has meant that we have been forced to totally reassess and stress test the ability of the borrowers to pay back their loans and make interest payments over the terms of the loans.

The results of our reassessments are that we still do not expect defaults amongst our investment grade bond selections. We also do not expect there to be impairments in the asset-backed securities or mortgage-backed securities that we own, due to the specific strengths of the selected instruments we own; in fact, these appear to us to be amongst the cheapest assets relative to their quality that we can find anywhere in the world. The areas where there is the highest chance of defaults is in US credits classified below investment grade ratings.

We have an allocation of around 4% in a Balanced portfolio to these markets and are taking a very credit-specific approach. We do not think that such investments can totally avoid the risk of defaults, but the yields on offer currently provide compensation against this risk and there are some extremely attractive opportunities in these markets.

What have we been doing in portfolios?

2020 has been a year of high activity across our client portfolios. The most recent changes we have made have been to add to equities in March and at the end of the first quarter to ensure that we were positioned for a recovery in global equities from "oversold" levels after the damage of March. In addition, we took advantage of the undeserved sell-off in gold equities in mid-March at extremely cheap prices. Having enjoyed a nearly 50% rise in gold equities since that decision to increase exposure, we have now started to take profits, although we still admire the long-term prospects for such investments. Our portfolios remain well-diversified and balanced, and we are ready to take advantage of the market volatility, such as we did with gold equities, that we expect to continue in the months ahead.

Thanks for your ongoing support. As always, we would be delighted to receive any further questions that you might have.

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