Brewin Dolphin - Weekly Round Up 03.04.2020

On to the plateau…

This week the main controversy is whether we are, or are not, seeing rates of infection in the UK topping out. It looks as if we are in some of the hardest hit European countries. Both Spain and Italy have seen the rates at which daily deaths increase slowing. Deaths are a delayed but more reliable indicator. In fact, as I write this the latest number of daily deaths in Spain is reported to have fallen.

Less optimistically the mortalities in the US and UK continue to grow steeply. In the UK at least we would hope to see that pace begin to slow over the coming week. The US has always seemed to be one of the greatest sources of concern. In America views on the virus have taken on a partisan flavour absent in the rest of the world and healthcare is delivered privately and funded by insurance. Responses comes through a strange mix of state and federal measures with states shouldering cost but not having the bottomless pockets of the federal government. How the US responds, its willingness to impose and abide by lockdowns, these are crucial uncertainties.

Riding out this first wave of the crisis is the current priority for everyone, discerning what the market expects in terms of a second or subsequent waves is another major risk. How different will things be once the lock down is lifted? We can’t be sure but the potential is there for:

1. Healthcare capacity to have been increased
2. For more testing of both cases, but potentially antibodies which might greatly ease the required lockdown and isolation measures
3. More testing would help policymakers to understand what kind of herd immunity has been developed.
4. There will be more knowledge of what has and has not been effective in halting the spread of the virus. How, for example has Sweden fared without imposing a lockdown? Are school lockdowns necessary?
5. Additional time to study treatments such as the four being trialled globally including Remdesivir, and Chloroquine.

Market conditions

Markets have plateaued as well with 5400 forming the new intraday base (at the time of writing at least). Sterling ground marginally higher at the expense of the euro, but nothing in the realm of the gains seen last when risk was rallying. Credit spreads were also reasonably static which belies a sea change which has taken place out of sight to chart watchers.

The investment grade bond market was largely closed three weeks ago after money market yields ballooned drawing investors away from high grade issues. Then two weeks ago it reopened with a vengeance recording successive record weeks of issuance ($109bn and 110bn in the US).

The Bank of England will begin buying sterling investment grade on Monday, announcing yesterday it had doubled the size of its purchase programme to **£**20bn. Unconnected but earlier in the week Shakhista recommend the Schroder Sterling Corporate Bond fund. It's a more aggressive fund which operates in smaller off the run issues but has been able to generate better returns are a result.

Also breaking records were inflows into high yield although these were masked by liquidity and the wrong kinds of supply with fallen investment grade issues entering the index. Refinitiv reported $7bn went into high yield, well above the previous record of $5bn set in 2016.

The effect of this on liquidity has been to flip from a state of having no willing buyer of bonds to having no willing seller. Prices quoted lurch higher when trying to deal and issuers are sitting back waiting for spreads to tighten before providing supply.

Dividends

Another unique feature of this episode is the sense of social responsibility which companies are exhibiting. Our Head of Equity Research James Box discussed how dividends have lost their sacrosanctity being cancelled or deferred more widely than would normally be expected. Foregone payments remain assets of the firm and ultimately of shareholders, but the inconvenience to clients and missed opportunity to repurchase shares at depressed prices is frustrating. From a longer term perspective instinctively it seems likely that many companies will consider operating with more working capital and maybe with less financial debt if they feel that it is necessary to have some resilience to these unpredictable events which maybe changes the long term outlook for some companies. We tend to focus on companies which have greater resilience and, where possible, are masters of their own destiny.

Fire, fire, fire, aim, aim, aim

Because of the rapid onset, from a developed world perspective it is the US, where the virus is landing last, that sees the first clear economic evidence of it. That reflects the timeliness of the US data but also quirks of the policy response. European policymakers have focussed on job protection while US policymakers have focussed on income protection. Therefore, while UK unemployment rates will rise quickly (7% based upon universal credit applications made so far), they will stay well below the levels of unemployment in the US. By contrast in the US benefits are in many cases above the level of in work compensation, in the UK many employees will be sustained in work through the government covering 80% of salaries.

The UK government also attempted to provide guaranteed loans to businesses and this kind of aid is another reason why paying dividends is a bad look for the bank sector at least. In case of doubt the Bank of England guided banks not to make distributions (dividends or buybacks) but did not include the coupons on additional tier 1 bank capital instruments.

The loans were slow to take off after lenders wanted borrowers to provide personal guarantees against the remaining 20% - something which rather spoilt the narrative that banks have gone from sinner to saviour in this crisis. It seems that such requirements have now been dropped. From an operational perspective, however, there could be a potential gap between the government's intent and the working level of execution given the sheer volume of small business funding applications to process.

Asset Allocation

This week saw our monthly group meeting on asset allocation. The outlook is clearly extremely uncertain but the challenges are in full view and are being met head on by a powerful policy response. The panic phase of the crisis has passed and market are functioning normally. The market is not phased by horrific economic news, expectations have been calibrated appropriately. Therefore, the risks remain more skewed to the upside than the downside over a reasonable time frame. We increased our weighting to Asian stocks at the expense of commodity producing emerging markets. The latter will benefit from a weakening of the dollar as risk appetite rises but remain exposed until that happens. Furthermore, when business reopens, capital investment seems likely to be a lower priority than repaying creditors. We also raised our exposure to UK equities at the expense of European equities. That reflected the deep discount which UK asset had fallen too.

One final observation that highlights the bizarre environment we are investing through before we hit the weekend. Google trends reveals that the terms unprecedented (red) and draconian (blue) have seen four times their usual usage since the service coverage began.