Coronavirus update

| 27 April 2020 |

This letter is an update on our thoughts on the coronavirus pandemic from an investment perspective. It is structured to answer three questions: What has happened recently? How has this changed our view on the outlook for growth? What is our view on investment markets and our current investment strategy?

At the time of our last letter, the spread of coronavirus had very recently driven the UK and large parts of the US (including New York and California) to join much of Continental Europe in entering lock-down. Since then the response of the medical community has been inspiring, however there has been little apparent progress in taming the virus. At the same time, the costs of the collective decision to shut down the social economy in order to lighten the viral load on our healthcare systems have become starkly obvious. In America, the locomotive of global growth, the most common measure of economic health, GDP, is predicted by many to shrink at an annual rate of over 25% in the current quarter, whilst lay-offs have already surpassed 10 percent of the workforce, and may double from here.

It is hard to imagine that the developed world has felt such widespread anxiety for such a prolonged period outside of wartime. Even those of us who are sanguine about the personal threat will almost certainly have become deeply concerned about our loved ones and livelihoods.

Financial markets, however, have rallied. From the end of March to the time of writing (27th April) global equities have risen by just over 7% in sterling terms. They now stand 10% lower than at the beginning of the year, having recouped over half their fall from the low point in early March.

Given the bleak backdrop already outlined, how can this be? The answer is that aggressive actions by governments and monetary authorities to offset the economic impact of their chosen antiviral measures have steadied investors' nerves. First, the financial "plumbing" (the interaction of the banking system with financial markets) was tested and found resilient in the face of an unprecedented demand for liquidity as the mood of investors and businesses worldwide switched from optimism to fear almost overnight. Second, fiscal programmes of unimagined scale and scope in peacetime have been passed. They already sum to more than twice the magnitude, relative to global GDP, of the stimulus applied in the Global Financial Crisis, but critically they have been agreed in a fraction of the time, since their aim is to preserve as much as possible of the economic fabric pending lock-downs, so that the rebound will be quick once those lock-downs are eased.

Rather than any specific measure, it is this clear demonstration that global governments and monetary authorities are acting in unison, that they are willing to do "whatever it takes" and that they also understand how to cushion the blow, that have together persuaded investors to look beyond the crisis rather than be transfixed by it.

So what comes next? In the immediate future, even if we see an extension of the encouraging recent trends on COVID19 infections and mortality, the economic and corporate news-flow will continue to be terrible. The measures outlined above preserve the capacity for an economy to bounce back after it has been shut down, but they do not replace lost revenues and income. On a best guess basis, and this is not a time for false precision, the developed world is operating only at around 70% of its level at the beginning of the year. Given the sudden sharp shock of this magnitude, it would be surprising if the corporate world as a whole is currently profitable at all. Comparisons with the Great Depression are eagerly made by the media, since the Great Depression also saw America lose around a quarter of its GDP in real terms. The comparisons are, however, dangerously misleading. The current shut down will be sharper, but much shorter, since the economic shock we are currently experiencing is voluntary, and extreme measures have been taken to preserve the infrastructure harmed by that choice. The measures to control COVID are creating pent-up demand, not destroying it, so we can expect to rebound quickly once the shackles are released. On an annual run rate basis, according to the IMF, the global economy is expected to shrink by around 3% in 2020, having started the year set for 3% growth. Unprecedented and painful, yes, but far different from the numbers that will confront us over the coming quarter, which will be measuring our economic performance at the most painful moment in time, rather than the likely average outcome over a year.

Our job now as investors, therefore, is to judge what the recovery will look like, rather than how deep the trough will be. This judgement has many component parts, but the key ones relate to the timing of releases from lock-down, the degree of permanent damage to the economic fabric sustained during lock down, the speed at which the undamaged economy can re-establish its efficient operating rhythm, and the likelihood of material recurrence of COVID19 necessitating a re-imposition of restrictions.

With so many unknown and unknowable variables, we must accept that there are many different possible outcomes. Our approach is to have a view on the most likely, but also to understand the alternatives. This reduces the risk of “anchoring” (the inability to move away from an already asserted position) and enables us to adjust our central view rapidly as evidence dictates.

Our current central view envisages a “U” shaped recovery, beginning in the UK alongside the rest of the world in May as the most stringent restrictions begin to be eased. The recovery will be gradual at first, as the restrictions will not be completely removed, supply chains will take time to restart and consumer confidence will take some time to recover. It is expected to gather pace in September, as supply chains are restored and meaningful re-stocking takes place, so that we will have recovered perhaps to 95% of the level at the start of the year by its end (as suggested by the IMF projections), a pattern again mirrored in the UK and the rest of the developed world. Further out, a slower growth trajectory will resume. Our central case assumption is that COVID19, although now endemic and therefore with us for the foreseeable future, will become manageable through testing and treatment even if a vaccine is not widely available until next year.

So what does this mean for our investment outlook and strategy? The central case outlook outlined above, we believe, gives cause for optimism. It suggests that the challenges we face in our daily lives, that are also faced by the corporate sector, will soon ease substantially. Looking to developed markets as a whole, earnings, which will be all-but eliminated in the near term, should rebound sharply as the year progresses and dividends, which have taken an unprecedented hit will be at least partly restored in 2021. Our best guess is that this crisis has "cost" share market investors about a year and a half of earnings and a year of dividends. If this guess is right and we view the intrinsic value of an equity investment or portfolio as the stream of income it will produce over 10 or 20 years, the theoretical permanent impairment to the value of share portfolios from COVID19 would be between 5% and 10%. However, we should remember that this is a central case. The possibility exists that things could turn out either materially worse, or indeed materially better than this outlook if the brightest and best minds in the global scientific community rise to meet this historic challenge and produce a vaccine sooner rather than later. The fact that little is known and the stakes are so high means, moreover, that elevated volatility in financial markets will be with us for some time to come.

What can we do in the face of such uncertainty? The answer is to practise investment on your behalf as we have always done. We continue to believe that our disciplined process, together with our focus on the highest quality investments and time tested portfolio construction techniques will deliver excellent outcomes for our clients over the longer term.

The letter above is written to show both what we think and, more importantly, how we think. We hope that it reassures you that we continue to deserve your trust in managing your financial affairs.

Please contact your portfolio manager if you have any questions.

John Haynes
Head of Research