Coronavirus update

| 16 June 2020 |

This letter is an update on our thoughts on the coronavirus pandemic. As with our previous letters, it is structured to answer three questions: What has happened recently? How has this changed the outlook for growth? What is our view on investment markets and our current investment strategy?

From the perspective of an observer of financial markets, the Coronavirus crisis has had three distinct phases. The first phase saw a dawning realisation of the scale of the problem and its potential impacts. Optimism turned to fear almost overnight and the suddenness of the transition from blue skies to the darkest of imaginable storms tested the financial "plumbing" (the interaction of the banking system with financial markets) with an unprecedented demand for liquidity. Innovative Government actions to counter the economic impact of lockdowns were crafted, but the accelerating pace of the outbreak and the risk that financial market turmoil could blunt their effectiveness put their success in doubt. Global stock markets measured in Dollars fell by just over one third from their highs in early February to the low on 23 March. The indiscriminate nature of the sell-off was reflected in its uniform impact across stock markets in the Developed and Emerging world.

The second phase, which can be loosely defined as the period from the low point to the end of May, saw an impressive rally in world stock markets, which rose by just under 35% in Dollars in that period, leaving global shares only 8% lower than at the start of the year when COVID was unimagined. The rally was built on three pillars: The first, most crucially, was an overwhelming monetary policy response, led by the Federal Reserve but supported by all central banks, that succeeded in stopping the rot. Deploying tools forged in the heat of the Great Financial Crisis (GFC), the financial system passed the test of ensuring funds were supplied wherever they were demanded. Their actions bought time for the crafting of a global fiscal response, built around furlough schemes innovatively tailored to the needs of the peculiar nature of the COVID crisis. Governments in Developed Markets then built confidence by displaying a "whatever-it-takes" willingness to scale these programmes up, providing reassurance that the fabric of the global consumer economy would be substantially intact when restrictions were eased. This in turn enabled investors to envision a more modest permanent impairment to the value of their investments as a result of COVID than had been feared. The third pillar was "good news" on the virus itself. Although somewhat more slowly, perhaps because of a more limited policy flexibility in open democracies, Europe's success in controlling COVID ultimately followed China's, allowing easing of lock-downs in both Europe and the US as May progressed. Hopes that the World Economy had passed its low-point were thereby underpinned, and investors were able to put misleading comparisons with the Great Depression behind them and focus on the future rather than the unpleasant present.

We are now in a third phase. Financial markets are no longer working "in the dark", with unreliable data and little knowledge of the adversary. Happily, the data confirm that the worst is passed. The consensus of the global investment community is now daily making (and revising) a sober assessment of the trajectory of the recovery, the amount of permanent damage done and the long term implications of the changes, some of them profound, catalysed by this extraordinary shock.

Our views on these key points are as follows: Our central case scenario, supported by the slow easing of consumer restrictions in Developed Markets (I write this on the day that the UK can once again go shopping for non-essential items) envisions a "U" shaped economic recovery (for the World and for the UK) slowly gathering pace through Q3, so that for the year as a whole the World economy sees a contraction of around 5% - a number consistent with the most recent World Bank projections. Thereafter, we expect a slower closing of the gap of lost output, so that the World Economy reaches the level seen just prior to the COVID lockdowns in the middle of 2022 – in other words the virus will have cost the World 2 ½ years of lost growth. Financial markets appear to be broadly discounting this outlook, as models using forecasts of dividends in 2022 (implicit in futures markets), discounted by current bond yields suggest that global stock markets are fairly valued, even though 2022 dividends on global shares are likely to be 20% below those paid in 2019. [Note: UK share markets have been hit more than most because of their high exposure to commodities and financials, whose dividends have been cut most severely. Futures markets suggest that the dividends on UK shares will still be 40% below the levels paid in 2019 in 2022, the difference between the experience in UK and the World as a whole is a powerful endorsement of the global diversification of equity portfolios].

The risks around this central case appear to us to be evenly balanced between possible positive and negative surprises. The negative risks are well known, and centre on a resurgence of the virus to the extent that economically damaging restrictions are re-imposed. Our view is that in 2020 at least, although rises in infections are to be expected as curbs are eased, material widespread re-impositions of lockdowns are unlikely. Viral surges are likely to be dealt with locally, with increasingly sophisticated tracking and individual quarantining techniques. Even large increases in incidence may not see dramatic re-imposition of restrictions, as recent protests in America and the UK on Racial Equality in defiance of social-distancing advice show that Democratic governments are already at the threshold of risking their authority. The possibility that things turn out better than the "central case" must also be acknowledged. Based on historical experience, there is widespread scepticism that medical science will deliver a widely available vaccine in time for next 'flu season, let alone in 2020. However, never before have the brightest and best minds on the whole planet been focussed on the same problem, empowered by government, with unlimited funding and big-data as an ally. Our view is that a treatment, or combination of treatments will become available in 2021, so that COVID will not be a recurring nightmare when infections inevitably surge again next year. A second source of potential positive surprise is the possibility of a strong consumer rebound. This has been widely dismissed, as psychological bruising and social distancing guidelines are expected to hold consumers back. However, the natural state of man is not mortal fear, and spending power pent-up in the COVID lockdown period could be quickly released if the resumption of the social economy rebuilds confidence rapidly.

The above outlines why our current stance remains sanguine and why we retain a broadly balanced investment position. We are, however, far from complacent. Aside from the possibility that our judgement on the virus is wrong, we must also assess the longer term consequences of COVID. It is recognised that the shock has accelerated the transition from physical to on-line commerce, changing patterns of work permanently. Some jobs are simply not coming back and we will be living with higher levels of unemployment than prior to the crisis for some time to come. The social and political aspects of this will add to the uncertainties, which rise as the year draws to a close with Brexit looming for the UK and a highly contentious US Presidential election due to be fought. From a longer term investment perspective, however, there are two new elephants in the room, obscured by day-to-day news-flow, which must be confronted. The first is the full blooded embrace of fiscal policy stimulus, including the printing of money by Central Banks, who are now buying debt securities directly from their own Governments as a way of financing their suddenly massive borrowing needs. The second is the blow to Globalisation dealt both by a re-examination of global supply chain vulnerability, and also by the damage to trust that underpins trade agreements. These issues throw up fundamental questions about both growth and inflation in the future, and they are at the heart of some of our most intense internal debate. The fact remains that little is known and the stakes are high, so 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 high 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