Weekly Digest

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To V Or Not To V

With apologies to the Bard, this is the question most exercising the minds of investors currently. The "V" refers to the shape of the economic recovery. You will recall that various letters of the alphabet, mainly "V", "U", "W" and "L" have been used to illustrate how activity might bounce (or not), alongside a few other shapes including the Nike "Swoosh", a hockey stick, a tick, a reverse square root and a barbed fish hook, just to mention a few I have seen. While none are particularly scientific, all answer the basic human need for an illustrated narrative, especially at points of maximum uncertainty. Where does the evidence currently point?

If one looks at markets, they are definitely swinging towards "V". This has been more notably the case in the last couple of weeks when leadership changed from Growth/Defensive sectors to Value/Cyclicals. It is worth reiterating the point that the initial bounce in markets from the end-March lows was highly anomalous, as it was led by the sectors that had been the winners beforehand. It was inevitable that the baton would be passed at some point, and that has occurred as economic activity has passed the trough while sentiment is bolstered by a steady flow of positive news on the relaxation of lockdowns across most of the world.

In terms of data, the latest batch of purchasing manager surveys (PMI) unequivocally shows that the worst of the storm has passed. For example, the UK Composite PMI rose from a trough in March of 13.8 to 30.0 in April. Yes, that still suggests that overall activity was lower than in the previous month, with 50 being the demarcation line between expansion and contraction, but the rate of deterioration is much lower, and that is what markets tend to trade off. Even more bullishly, last Friday's monthly employment report in the United States saw private payrolls increase by more than three million in May, when the consensus forecast was for a further 6.75 million job losses. The unemployment rate dropped from 14.7% to 13.3%, when expectations were for a rise to 19%. Even allowing for some potential glitches in the gathering of data and the fact that some of this hiring is only in anticipation of a future recovery in activity, the number was extraordinary. Indeed, it completely bypassed the "second derivative" phase of slower deterioration, going straight into full-on recovery. Hence an unequivocally "risk-on" market response.

As wonderful as all of this might sound, it presents something of a problem for investors, at least many professional ones. The performance of most of the investment industry is measured not in absolute terms, but in relative. How has your fund fared relative to, for example, its own asset allocation benchmark, industry peers or a specific index? While conservative managers, or those highly committed to technology innovators and disruptors, might have "had a good crisis" so far, the resurgence of Value/ Cyclical sectors is eating into those relative gains.

That's not to say that those managers are not making positive absolute returns, but "fear of missing out" can induce uncharacteristic behavior. The squeeze is exacerbated by what still appear to be high average cash levels across the industry.

I have to admit that we find periods such as this a bit uncomfortable. Our long-term preference is for higher quality companies, defined by good management, a robust business model, sustainably high cash flow returns on investment and, perhaps most crucially, strong balance sheets. That is to say we tend not to get involved with companies that might just as easily go bust as prosper. While that approach has stood us in good stead since the outbreak of Covid-19, we will, in all probability, lag the market a bit if the rally continues in the same fashion. As I have written about on several occasions in the past few years, Value/Cyclical rallies since the financial crisis have tended to be short-lived, and that does not suit a wholesale tactical rotation of portfolios. We would want to see far greater evidence of a prolonged period of higher sustainable growth and potentially also higher inflation to make that call. Of course, we do own more cyclical stocks, but they will generally be the higher quality situations within their sectors. During this crisis we have also attempted to identify some companies where the market is, in our opinion, mispricing the probability of survival (that is pricing in a possible bankruptcy or hugely dilutive capital raise which we do not view as probable) and suggested that managers might consider "renting" these for the recovery phase.

Returning to the economy, is this "V"-shaped recovery as probable as the market is suggesting? Much as I think we would all like it to be from the perspective of getting our lives back to normal, there is still plenty to worry about, and thus more good reason for us not to want to make a big bet on Value/Cyclicals. First of all it looks clear that all sorts of physical constraints are going to remain with us for a while yet, and so it will be very difficult for many service industries to return to previous levels of profitability, especially given the increased costs required to fulfil new safety requirements. The only way they might achieve it is through shedding staff and renegotiating rents, but that only passes the buck. Most economists do not see overall levels of activity returning to previous peaks until late 2021 or 2022, and while it is perfectly acceptable for the market to look through that period and value companies today on recovered earnings, it doesn't leave much cushion for anything to go wrong in the interim.

As we have often repeated, the achievement of herd immunity either through vaccination or the majority of the population being infected is the only viable way to return to what we think of as normal. Until then, there will be a sufficient percentage of the population that will remain risk-averse and will spend well below their potential. The flip-side of this argument is that savings accumulated during lockdown will be unleashed into the economy at some point, but the nineteenth century economist David Ricardo countered this idea with his theory of Ricardian Equivalence. This postulates that individuals calibrate their consumption according to the life-time present value of their after-tax income. Thus they won't see one-off hand-outs from government as recurring gifts. More pertinently, if they perceive that government debts will have to be balanced at some point by increased taxation, they will increase current savings to account for that. Recent polls have shown support for higher taxes, notably on companies that have benefitted from the Covid crisis (and I don't refer to "price gouging" here, just having the right business model for the times) and also individuals with "wealth" greater than £750,000. Add to that the fact that both the household and corporate sectors might well feel that recent events have highlighted the need for more of a financial cushion, then, bar perhaps an initial relief splurge, there is plenty of reason to be cautious about future spending.

Finally, in the Sherlock Holmes story The Adventure of the Empty House, who committed murder to avoid being exposed for cheating at whist?
Colonel Sebastian Moran

This week, against which team was Kevin Moran playing in 1985 when he became the first player to be sent off in an FA Cup final?

Last week's Economic Highlights

UK – There is no doubt that activity is bouncing from the trough, but it remains well below pre-crisis levels. Car registrations in May, for example, might have been 3 times April's level, but they are still down 90% from a year ago. Consumers repaid £7.4bn of their debts in April, mainly because spending opportunities are limited and travel refunds continue to roll in. One positive factor is the resilience of house prices, which, according to Nationwide, fell just 1.7% in May. Ultra-low interest rates will continue to be supportive.

US – Employment data was the highlight of the week, with 2.5 million jobs being created overall. The fact that private sector gains were more than 3 million is testament to cuts at local government levels, as states and cities struggle to deal with a huge loss of tax revenue. Another interesting quirk is that average hourly earnings are rising 6.7% per annum. That's not in fact huge wage inflation, more that it's the lower-paid workers who have lost their jobs in this downturn.

Europe – The ECB left interest rates unchanged at -0.5%, but increased the size of its crisis asset purchase programme by €600m to €1,350m. This gives purchasing firepower well into 2021, and provided a solid boost for the bonds of highly-indebted peripheral countries.

China – May's trade surplus came in at record $62.9bn. From a global perspective the number was both good and bad. The positive surprise came because exports fell less than expected and no more quickly than last month (good, as it implies that, ex-China, Covid impacts have stabilised earlier than expected), but the 16.7% fall in imports was also a lot more than expected, suggesting that the boost to global demand provided by China's "re-stocking" phase may also be largely over.

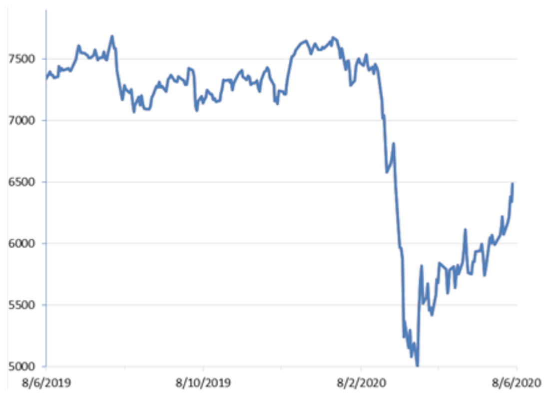
FTSE 100 Weekly Winners

IAG	43.3%
Carnival	35.4%
easyJet	31.1%
Rolls-Royce	31.0%
Melrose Industries	15.9%
John Wood Group	27.2%
Micro Focus International	26.7%

FTSE 100 Weekly Losers

Hargreaves Lansdown	-11.2%
Fresnillo	-8.8%
Reckitt Benckiser	-4.8%
Ocado Group	-3.1%
Rentokil Initial	-2.7%
GlaxoSmithKline	-2.0%
AstraZeneca	-1.8%

FTSE 100 Index, Past 12 Months



Source:FactSet

This Week's Forthcoming Events

UK	Industrial Production Y/Y
UK	Manufacturing Production Y/Y
US	FOMC Meeting
US	CPI NSA Y/Y
US	Michigan Sentiment
EU	GDP SA Y/Y (Final)
EU	Sentix Economic Index