COMMENTARY

1st January to 31st March, 2020

Regular readers of our quarterly commentaries will hopefully recognise that we tend towards a more measured style, rather than a "shouty", sensationalist approach favoured by writers who are obliged to compete for readers' attention. On this occasion, however, it would be almost impossible to over-exaggerate the significance and severity of the quarter's events at both a human and economic level.

As we are neither virologists nor epidemiologists, we cannot profess to have any specialist knowledge or useful insights into the likely way that the COVID-19 pandemic will develop, or ultimately end. As such, we will confine our observations and comments to matters that relate to asset management. It has been said many times already that we are truly in uncharted territory. Pandemics are not a unique phenomenon, but the global reach of the one we are currently experiencing, the (for now) open-ended nature of the measures put in place to tackle it and the consequent effect on huge swathes of global economic activity make the current situation uniquely challenging.

What is clear from the data published so far - Purchasing Manager Indices from the major economies, industrial output figures, US employment numbers, etc – is that the world's economy is in the throes of downturn, the depth and speed of which are without precedent. Importantly, so too are authorities' responses to this crisis. On a more encouraging note, however, signals from the virus's ground zero, China, suggest the path to at least a partial recovery can be swift, albeit the sustainability of that recovery, being event-driven is, as yet, unclear.

Past bear markets and recessions are certainly instructive in informing a response and guiding our strategy, but there remain many "unknown unknowns". Aspects of the Great Depression of the 1920s and 30s arguably come close, but unless the experts have it badly wrong, the likely duration of the downturn will be months rather than years and the joined-up nature of the global economy and monetary landscape, as well as the speed and efficiency with which financial markets operate, mean that the world is very different now. Comparisons with 1987's market crash, though perhaps valid from a time scale perspective, also fall wide of the mark due of the very different economic situation that prevailed. Even within the context of the 2007 / 09 global financial crisis, there are few, if any, precedents for the movements that took place in financial markets, if not perhaps in terms of their quantum, then certainly in the rapidity with which they took place. Arguably the closest parallel that can be drawn are the events surrounding the Lehman's collapse in September 2008. Crucially, however, whereas the focus of that particular episode was the banking sector and associated parts of the financial system, the economic impact this time around is far broader.

Equities

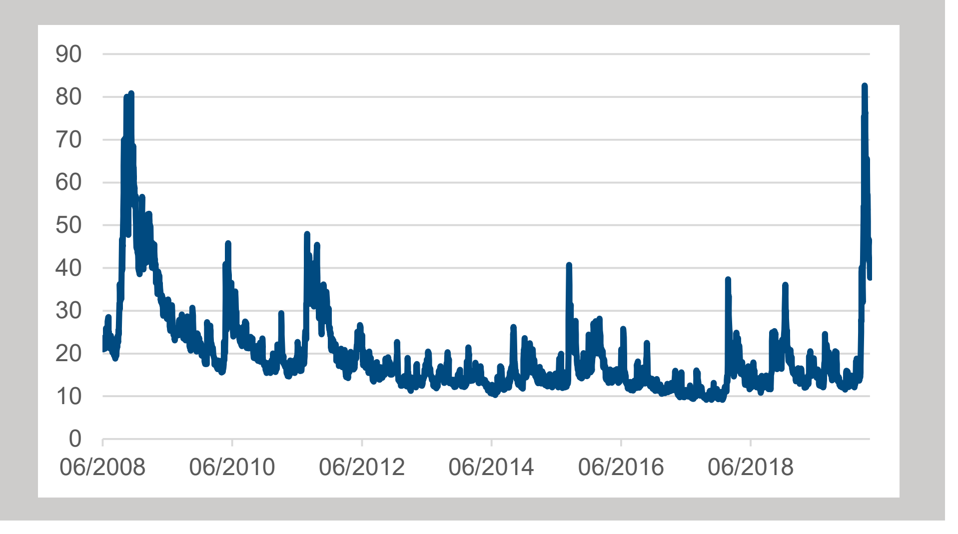
As painful as the figures in the table overleaf clearly are, there was a point in the third week of March during which things looked a whole lot worse, with the MSCI World (local currency) Index down more than 34% at a 45-month low. If reports are to be believed, a significant contributor to this downward spike was forced selling by leveraged investors raising liquidity to meet margin calls, which in turn triggered trades by systematic strategies that generated further algo-driven selling – for a brief period, the sense of panic and helplessness that sent volatility indicators to levels that surpassed those at the peak of the 2008 crisis was almost overwhelming.

Equity Market Indices

Index	Q1-2020	2019
MSCI World ($)	-21.44%	+25.19%
MSCI World (€)	-19.60%	+27.68%
MSCI World (£)	-15.96%	+20.31%
MSCI World (local ccy)	-20.49%	+24.86%
S&P 500 ($)	-20.00%	+28.88%
FTSE UK All Share (£)	-17.96%	+14.19%
MSCI Europe ex-UK (€)	-21.30%	+24.08%
Japan Topix (¥)	-18.49%	+15.21%
MSCI Asia ex-Japan ($)	-18.60%	+15.37%
MSCI Emerging Markets ($)	-23.87%	+15.42%
MSCI Emerging Markets (€)	-22.08%	+17.71%
MSCI Emerging Markets (£)	-18.56%	+10.92%

Source: Bloomberg

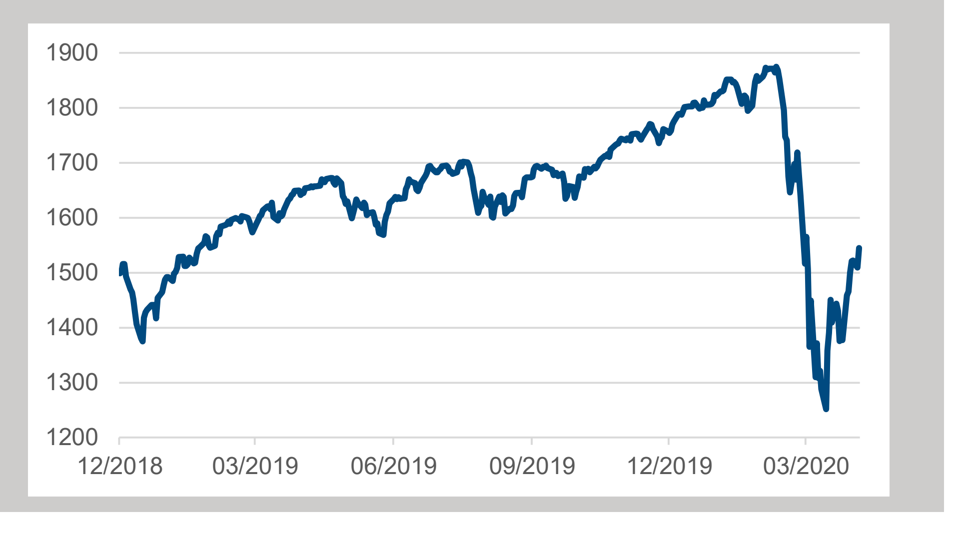
VIX Index



Source: Bloomberg

This negative feedback loop was halted by the actions of central banks and announcements from governments of a raft of monetary and fiscal measures to support economies, businesses and households that reflect not only a determination to prop up markets and economies, but also the scale of the challenge at hand. Markets' rebound in response to these measures means that, at the time of writing, we have witnessed by technical definition, both a bear and a bull market in the space of just four weeks.

MSCI World Index (local ccy)



Source: Bloomberg

In many respects, the biggest challenge facing equity investors currently is the lack of earnings visibility resulting from the effects of shuttered economic activity and population lockdowns.

How do we value markets and individual companies without historic comparisons for the data and reference points on which we rely and with little clue as to how long the hiatus and consequent effects will last? On the other hand, that absence of visibility could be viewed as being helpful, since the removal of short-term distractions affords a greater focus on the fundamental characteristics of specific investments, their long-term prospects and the opportunities on offer.

Though there are relatively few industries, sub-sectors or companies that are clear beneficiaries of the current situation, the list of obvious and potential casualties is extensive. Indeed, after an extended period during which easy monetary conditions have sustained inefficient and badly run ("zombie") businesses that, in normal circumstances could be expected to fail, it seems inevitable that the Darwinian process now underway will see a major re-set within the corporate environment. This makes active stock selection, rather than a passive index approach, more important than it has been for a number of years.

Reports from our preferred equity fund managers certainly support this and the emphasis that they collectively place on crucial qualitative aspects such as balance sheet strength resilient cash flow drivers and superior governance mean that they (and by extension, our portfolios) are well placed to profit from economies' and markets' eventual recovery.

Bonds

As suggested by the returns recorded by their respective benchmarks over the quarter, core sovereign debt markets represented a rare safe haven amidst the widespread and sizeable falls in other asset classes – the Bloomberg US, German and UK Government (all>1yr) indices were up 8.20%, 2.09% and 6.80% respectively for the period, driven by the decline in yields to record lows. As was the case elsewhere, however, the path to these returns was anything but smooth and at one point during the all-encompassing sell-off that occurred during March, those benchmarks suffered respective drawdowns of 5.01%, 4.92% and 9.60%, as measures of bond market volatility reached a ten-year high.

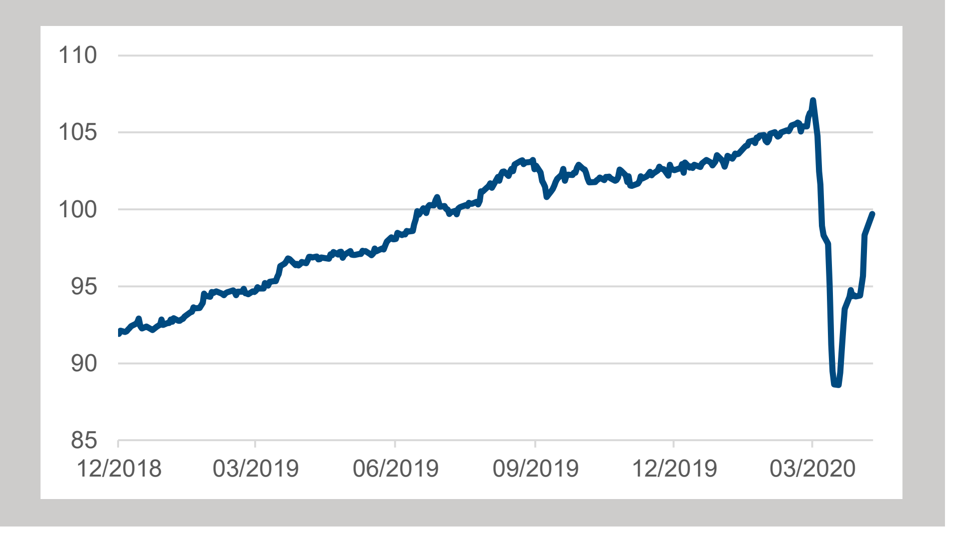
Sharp rises in credit spreads, which began in late February and accelerated into March, far outweighed any positive pull from declining Treasury, Bund and Gilt yields and made for big falls in investment grade corporate, high yield and emerging market sovereign bonds that erased most of their benchmark indices' gains for the previous twelve months . As was the case right across the piece, government and central bank announcements of massive stimulus measures, which, uniquely, for the US, included support for the high yield market, went some way towards calming investors' nerves. The latter part of the quarter saw some retracement of those credit spreads (which has continued beyond the quarter-end) from levels that, whilst not on the same magnitude as those in 2008/9, are certainly towards the top of historic ranges.

Our long-held positioning in fixed income markets, which is focused on strategies with a low degree of interest rate sensitivity (duration) and a high credit component, offered little in the way of protection from the prevailing risk-off environment. The indiscriminate nature of much of the selling that was, in many instances, the function of a panicked scramble for cash or driven by passive investment flows means there has been little qualitative distinction between borrowers or individual bond issues across many areas of the fixed income space.

Accordingly, although we can expect to see a rise in defaults within specific sectors - energy, retail and leisure for example - large parts of the market that will survive the economic downturn and continue to fulfil their debt obligations have, in pricing terms, suffered a similar fate to those that will fail. Based on dialogue with, and reports from, our preferred managers, these inefficiencies present opportunities for skilled and well-resourced credit specialists that promise outsized returns with a high degree of predictability. Moreover, those with sufficiently flexible mandates have been re-aligning their portfolios to take advantage of this.

As such, thanks to bonds' inherent characteristics (fixed coupons and repayment dates), we can have a high degree of confidence that the drawdowns we have experienced represent a temporary reversal. The healthy gains seen during the brief period since the quarter-end certainly support this.

iBoxx USD Corporate BBB Price Index



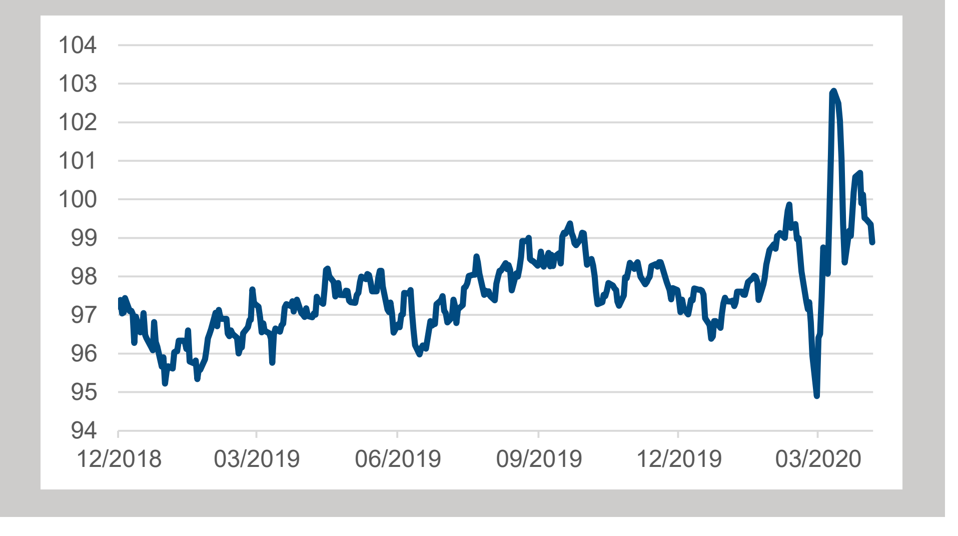
Source: Bloomberg

Currencies

Unsurprisingly, Japanese Yen, Swiss Franc and US Dollar – the "go to" currencies in times of distress – fared best (in that order) on the foreign exchanges over the quarter.

As measured by the DXY Spot Index, the Dollar gained 2.76% in trade-weighted terms, but in keeping with the volatile times, saw swings of -4.99%, +8.35% and -4.33% between the last week of February and the end of March.

DXY USD Spot Index



Source: Bloomberg

Emerging market currencies crowded the bottom end of the FX performance league table, with the Brazilian Real falling by 22.58%, the South African Rand -21.48% and Mexican Peso -19.62% in USD terms. Meanwhile, the Norwegian Krone, Australian and New Zealand Dollars also posted double-digit falls. Whereas these last three (developed market) currencies (and to a lesser extent, the Mexican Peso) all closed meaningfully above their intra-quarter lows and have continued to recover during the interim and broad EMFX benchmarks continue to languish at historic lows.

JP Morgan EM Ccy Index

Source: Bloomberg

Commodities

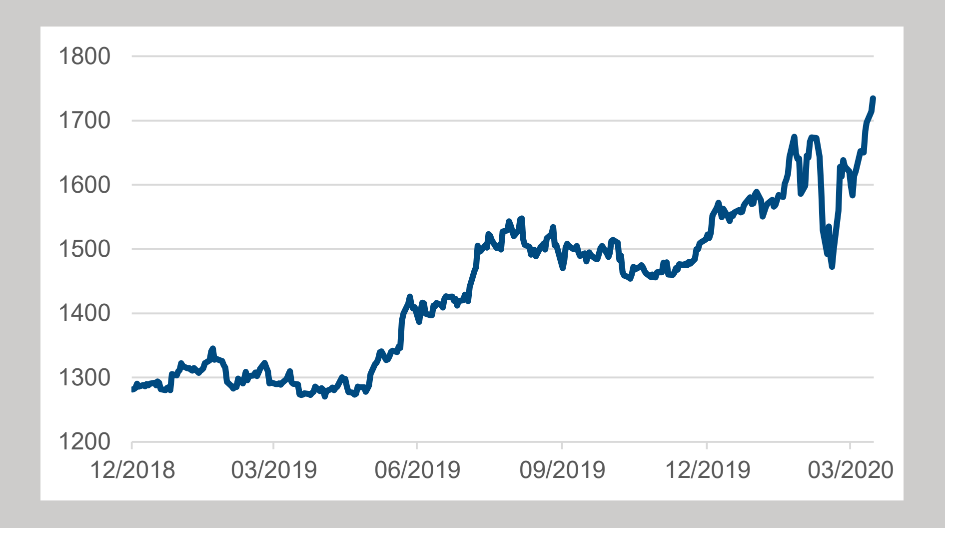
Broad Commodity benchmarks were down heavily over the quarter, with prices in the energy complex recording the greatest moves (see below). The Bloomberg Commodities Index fell 23.53%, whereas the Rogers International Ex-Energy Index lost 12.97%, both in USD terms.

If the effect of shutting down a significant proportion of the world's energy-consuming activity wasn't damaging enough for crude oil prices disagreement ("price war"?) between the world's largest producer nations, Saudi Arabia and Russia, over a co-ordinated supply response added further to the downward pressure. After a weak opening to the period that sent the front-month futures contract for West Texas Intermediate (WTI) from an opening mark of $60 per barrel down through $50 as the China-slowdown began to take its toll, the "sell everything" phase of the markets' collapse saw both the $40 and $30 levels breached within the space of a week. At the quarter-end, that WTI contract was at $20.48bbl, a fall of 66.46% for the period, while the equivalent price for Brent crude was off 58.88% at $26.35bbl – levels not seen since February 2002. More recently, an improved dialogue between the major OPEC and "NoPEC" producers has offered the prospect of reduced supply, which may go at least some way towards both stabilising energy prices and easing pressures on storage capacity, as inventories hit or approach record levels.

Though clearly harmful for petro-nations and potentially fatal for higher-cost producers (without a swift reversal, widespread corporate failures across the energy sector seem inevitable), the positive effects of lower energy prices – most obviously on lower inflation, input costs and (significantly) for countries that are energy importers - should also not go unrecognised. With respect to the last of these, reports that China has been adding aggressively to its strategic reserves, whilst also looking to add further to storage capacity, are another example of a shift in long-term dynamics that may prove irreversible – the crucial factor here being time.

As one of my colleagues commented during a recent team conference call, given both its traditional safe haven status, negative correlation with real interest rates and the perception of being the ultimate long duration asset, it is difficult to conceive of a situation in which gold does not benefit from the current scenario. While that ultimately proved to be the case, the quarter was certainly not without its moments. Even amid reports of an acute shortage of coins and small bars among retail dealers, the spot bullion price dropped by almost 12% during the mid-March panic attack before recovering most of that intra-period slump to end the period up 4.93% in USD terms at a price of $1,597.89 – a little way from its February 24th (7-year) $1,675 high, but, from a technical perspective, with its upward momentum intact. With gold representing one of the few hedges against declines in risk assets, we have been happy to allow weightings within portfolios to grow versus those in our models - a position that is likely to remain in place for the time being.

Gold Spot USD per troy ounce



Source: Bloomberg

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