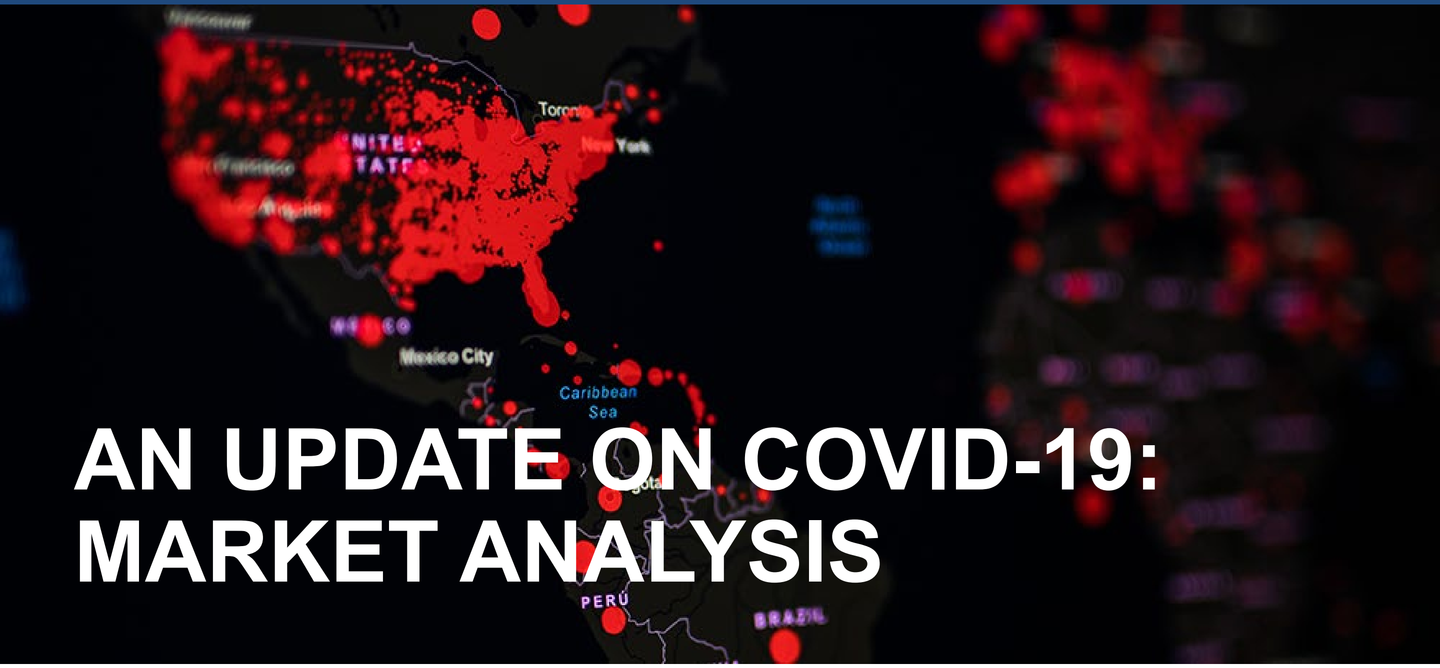

AN UPDATE ON COVID-19: MARKET ANALYSIS

It feels a little disrespectful writing about markets when there is so much human tragedy and human heroics in evidence. However, we thought it would be useful to give a brief summary of what has happened since my last missive, which was written as markets were falling rapidly back in March (click here to view that article). We said that it will be the reaction of authorities to curb the spread of Covid-19, rather the actual impact of the disease itself, which will impact economies. What was originally thought of as a local problem in Asia soon became a global pandemic, with Italy becoming the next epicentre, and then on to the US. It wasn't till the catastrophe in Italy started to unfold that markets really cottoned on to how severe the impact of this disease was going to be for the global economy. As we said then, and continue to believe, it is impossible to calculate the economic impact of the virus. The IMF made an attempt, and initially said that they expected global economic growth to contract by 3% this year. Now they are saying that this may have been too optimistic. In March economists were talking about a 'V' shaped recovery. Now in true form, economists are discovering both their hands. As President Harry Truman once said 'please give me a one handed economist', there are far too many 'on the other hand's out there at the moment.

In our view, there are three main reasons why things remain unclear: firstly, the virus itself and the continued reaction by the authorities. The fear of a second wave and the uncertainty of whether people that have had it will stay immune means that there is unlikely to be a complete opening up of economies. Until there is a definitive solution to this novel virus, like a vaccine or drug to help cure patients, some forms of restrictions are likely to stay in place.

Secondly, the reactions after it is all sorted out are unknown. The shortages we have seen in PPE due to reliance on overseas production is a microcosm of what is happening globally. Governments and companies are likely to start re-thinking their 'Just-In-Time' inventory methods and their reliance on supply chains that stretch across the globe. They are likely to start thinking about strategic, 'must have ready' goods to be stored locally at all times. As we said back in March, this, plus Trumpism, is likely to reverse globalisation, which has been one of the biggest forces holding down inflation. How people will behave is very unclear. Even when we are all let out, how many will flock to the bars of London? How many will get on a plane so readily? Interestingly, we did some work on similarity of market move patterns in history. Apart from 1987, which is what this episode reminded me of, there was also a similarity to 1946. As I wasn't around to witness the latter, I looked back to see what happened. This was post WWII. After the celebrations, came the reckoning. Markets started to ask how all the government expenditure would be repaid. Also people started to save. Despite the ludicrously low level of interest rates, that could happen now. Many, many people will have suffered from the 'Great Lockdown' as the IMF has termed it. In the US they are talking about unemployment rising to 20%, not heard of since the 1930s. Although authorities are doing all they can to mitigate this, there will be a deep scar felt by the population as a whole, and saving in case anything like this could happen again, would not be illogical.

That leads us nicely on to reason three. The reactions by the authorities have been simply extraordinary. Take a look at the US. The Federal Reserve brought down interest rates twice in March (3rd 0.5% and 15th 1%) so a total of 1.5% to basically zero. Lowering interest rates is not helpful in our view, but for borrowers it's a help. By 23rd March they had promised unlimited Quantitative Easing (QE). This included buying corporate bonds and municipal bonds. They flooded the markets with cash, they even put in place support to help Money Market Funds. They eased bank capital requirements. They sought the help of BlackRock to help them purchase ETFs (Exchange Traded Funds). One of the fears that many central bankers had, long before this crisis, was that if investors started to sell out of Fixed Interest index trackers like ETFs, the illiquidity of corporate debt markets could cause a panic and disrupt the system. Getting BlackRock to help is very much poacher turned gamekeeper, and smacks of conflicts of interest. Originally the Fed were only going to buy investment grade debt, but since the ratings agencies started to wake up to events and downgrade corporate debt, they will also buy junk debt. This is because 'fallen angels' like Ford could upset the system as they move from investment grade indices to 'junk' indices.

The amount of printed money coming on-line from the Fed makes the QE of 2008/9 look insignificant, and it's only just beginning. It's not just the Fed dishing out the Trillions, the US government initiated a $2.2 trillion aid package to help hard hit industries, which was on top of a $2.3 trillion package rolled out by the Fed in April, to help local governments and small and mid-sized companies. That's just the US. In the UK, the Bank of England has lowered rates to 0.10% (two cuts on 11th 0.5% and 19th 0.15%) and it's restarted QE. Not only that, it has enabled the government to have money directly through the Ways and Means fund. This has enabled our new Chancellor to spend copiously with various programmes, not least the government paying 80% of salaries for furloughed staff. We had never even heard of furloughing prior to this.

We could go around the world listing the amounts of money being created to be spent by governments on reducing the economic and individual impact of the virus. Very simply we are witnessing a monetisation of government debt globally. All this liquidity has to go somewhere, whether spent or saved. This is why economists have no idea how things will unfold.

As far as our model portfolios are concerned we have obviously been hit by the market volatility. We must remember that when we invest, we are not buying GDP growth, we are investing in companies that produce goods and services. In some cases their services have been severely curtailed, for example airlines and hospitality companies like pubs and restaurants.

Our models have always had a bias towards the UK in our equity exposure, except for our SRI Adventurous model. In the short term this has impacted relative performance. In the market falls, the UK was the hardest hit of all the major markets. We believe that this is partly due to the impact of index tracking funds like ETFs. The main indices are weighted by capitalisation, meaning the biggest companies carry the biggest weights in the index. In the top ten holdings you have 7.6% in Shell and 4.7% in BP. Thanks to the spat between Putin and Saudi Arabia, there was no agreement on limiting the production of oil. Couple this with the plunge in demand for the black stuff, as in hardly any planes, less cars etc., and you had a perfect storm. In fact on 21st April the price of West Texas crude fell to over minus $30 a barrel. That's right – they were paying people to take the stuff off their hands. The reason being that most of the US oil storage was full, so if you were taking delivery of oil, you had nowhere to put it. This sudden plunge was due to expiry of the May futures contracts, when nobody wanted to take delivery. Usually these contracts are 'rolled over' and cash changes hand for the difference. Already the June futures are looking vulnerable.

As a whole the UK market is often seen as being impacted by oil. We also had the Bank of England lean on the banks to not pay dividends, as they wanted the banks to use money to help virus impacted industry. A quick look at the chart below shows what that has meant (look at year to date column):

	Mth so far	YTD	1m	3mth
	31/03/2020	31/12/2019	29/02/2020	31/12/2019
Sector/Company	28/04/2020	28/04/2020	31/03/2020	31/03/2020
IA UK All Companies	7.58%	-22.45%	-18.43%	-27.92%
IA UK Equity Income	6.02%	-23.82%	-18.30%	-28.14%
IA UK Smaller Companies	11.89%	-21.63%	-22.50%	-29.95%
MSCI World	9.20%	-12.74%	-12.84%	-20.10%
Barclays PLC Ord 25P	3.88%	-43.47%	-36.73%	-45.58%
BHP Group PLC Ord USD0.50	6.52%	-22.24%	-8.55%	-27.00%
BP PLC USD0.25	-6.42%	-30.77%	-13.11%	-26.02%
AstraZeneca	13.47%	9.84%	6.21%	-3.20%
Royal Dutch Shell	0.97%	-34.70%	-14.59%	-35.33%
Rio Tinto	1.44%	-12.16%	8.08%	-13.40%
GlaxoSmithKline	11.42%	-3.82%	-3.05%	-13.68%
HSBC Holdings	-7.42%	-26.76%	-13.29%	-20.89%
British American Tobacco	13.43%	-1.29%	-8.18%	-12.98%

Source: FE Analytics

Continued overleaf

The problem with index tracking funds is that the 'bias' thinking, like FTSE100 is an oil orientated index and the FTSE250 is a domestically orientated index (think Brexit), means that investors buy and sell these funds with that in mind regardless of what the other constituents are. As such the baby gets thrown out with the bath water. However, as we move forward, the notion of buying an index is likely to be questioned, as it is far more important to know what companies are doing, and how they are likely to survive. We would therefore expect our bias towards the UK to come back to help us as it did last year after the Brexit politics were resolved.

In general performance terms, our holdings in our SRI models have done better than their respective peers.

For example, over the last three months (to the end of March, according to FE Analytics) Liontrust Sustainable European Growth fund was in top quartile, Impax Asian Environmental Markets fund was top quartile. All three of our UK Equity Income holdings were above their sector averages.

Looking forward, we would expect companies providing solutions to mankind's problems to continue to survive and thrive. Whether it's alternative energy, providing water solutions, waste management, health, resource scarcity, or food, these are companies whose services will be needed. Speaking to fund managers of our underlying funds gives us insight into how they are doing. One fund manager said that when he asked CEOs of companies in which he invests whether earnings in 2021 will be as good as 2019, most said they expect them to be better. So despite the strange times in which we live, that should give us all some comfort in our investments.

Paul Warner
Head of Portfolio Management (UK)

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