COMMENTARY

1st April to 30th June, 2020

Evidenced by a steady stream of troubling statistics, the COVID-19 virus continues to exact a heavy toll in both human and economic terms as it traverses the globe from east to west. Although the progression, impact of, and events relating to the pandemic dominated the mainstream and financial news flow, widespread protests over racial injustices and a resurgence in geopolitical tensions were also a notable feature of the period under review.

Fuelled in no small part by global authorities' largesse in the form of massive fiscal and monetary stimulus, the turnaround in investor sentiment that began in March persisted for much of the quarter, lifting risk assets' prices from earlier depressed levels. Whereas core sovereign bond benchmarks ended little changed, yield spreads narrowed meaningfully across the credit spectrum and strong gains in equity markets saw broad global indices climb steadily, before pausing during the period's latter stages. A softer dollar, along with higher oil, base- and precious metal prices rounded out the big picture summary.

Equities

As debate and speculation among economists, strategists and commentators over the likely shape and time scale of the global economy's eventual recovery continued - L, U, V, W, the "Nike swoosh"? - investors chose to focus on the dizzying amounts of liquidity injected into the financial system and, heeding the mantra that "you can't fight the Fed", sent equity markets on a tear throughout April, May and early June.

MSCI World Index (local ccy)

Source: Bloomberg

Equity Market Indices

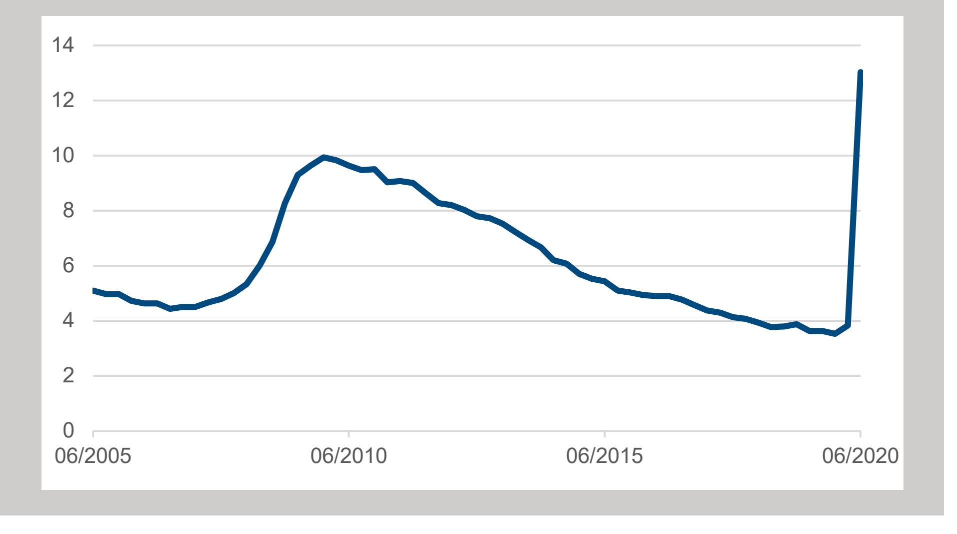
Index	Q2-2020	YTD
MSCI World ($)	+18.84%	-6.64%
MSCI World (€)	+15.97%	-6.76%
MSCI World (£)	+19.02%	+0.02%
MSCI World (local ccy)	+17.95%	-6.22%
S&P 500 ($)	+19.95%	-4.04%
FTSE UK All Share (£)	+9.77%	-18.72%
MSCI Europe ex-UK (€)	+13.58%	-10.40%
Japan Topix (¥)	+11.10%	-9.45%
MSCI Asia ex-Japan ($)	+16.82%	-7.15%
MSCI Emerging Markets ($)	+17.27%	-10.73%
MSCI Emerging Markets (€)	+14.43%	-10.84%
MSCI Emerging Markets (£)	+17.45%	-4.35%

Source: Bloomberg

For the most part, markets' positive performances were in sharp contrast to the economic data from the major economies, which set out in stark and painful detail both the path of the pandemic and the extent of the global economy's COVID-induced woes.

Though it would be difficult to adequately describe in words the speed and magnitude of the collapse in activity, the figure for the EU's composite Purchasing Manager's Index of 13.7 – down from 51.6 in February; 50 signifies the divide between expansion and contraction – is an excellent representation of the facts. Though the corresponding number of 27.0 was not quite so severe, the jump in the US's unemployment rate from 4.4 % in March and a prior February figure of 3.5% to 14.7% certainly was, as a staggering (net) 20.5 million jobs were lost during April. If some comfort can be taken from the knowledge that subsequent releases suggest April represents the bottom of a very steep V-shaped pattern, even the later, improved, data are desperately weak by historic comparisons and a full recovery to pre-pandemic levels is some way off.

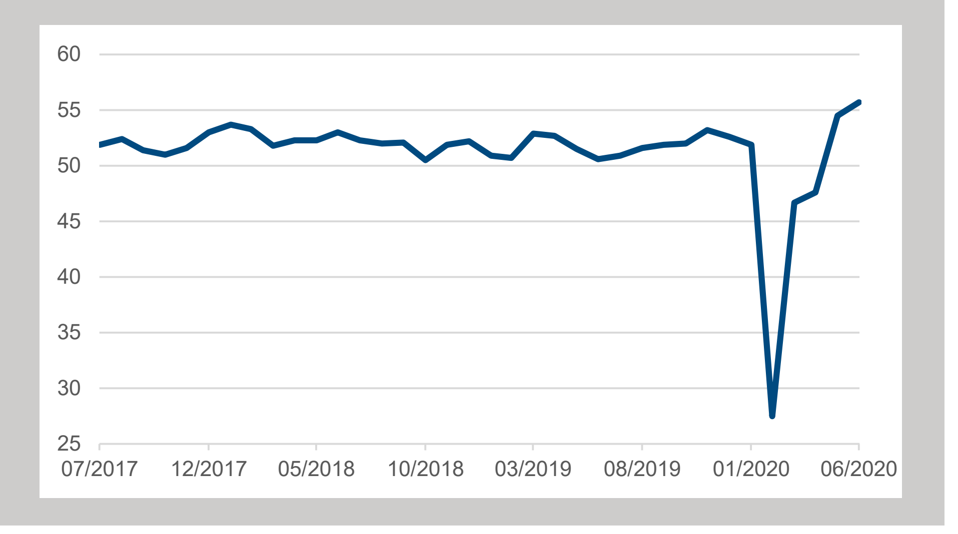
US Unemployment Rate (%)



Source: Bloomberg

Notwithstanding the very different ways in which its economy is controlled and in which the pandemic has been managed, when seeking the silver lining to this very dark economic cloud, we should look to China for at least an idea of what could come next for western economies. There, the composite PMI troughed at a level of 27.5 in February and has recovered very quickly to 55.4 in June; importantly, for those amongst us that view official statistics with a healthy degree of scepticism, this has been corroborated by (more reliable?) independent / non-government sources. Though we would not suggest for a single second that one should expect an identical rebound in the old and new worlds, the prognosis for the direction of travel is at least encouraging.

Caixin China Composite PMI



Source: Bloomberg

Since the textbooks tell us that stock markets are a discounting mechanism for future corporate earnings, the forthcoming Q2 reporting season should, in theory, have little impact on equity indices. It will therefore be interesting to see how markets react to quarterly figures that will reveal in sharp relief companies' contrasting fortunes across the range of industry sectors during the early stages of economies' lock-down. Given the sudden nature and duration of stoppages, the extent of supply chain disruptions and the varied impact on demand patterns, it will be some time before a clear picture of the true effect on earnings is known and that doesn't even begin to factor in the shape and pace of the future recovery. That lack of clarity means that investors are running blind to a far greater degree than normal and any judgement as to whether valuations are cheap, fair or expensive is more of a subjective matter than anything else.

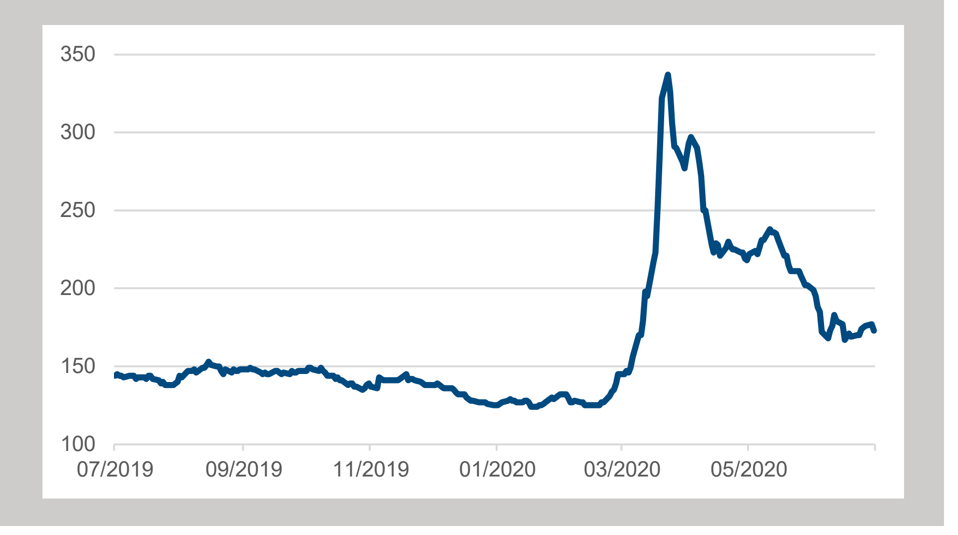
For what it's worth, our assessment is that prevailing valuations are at or very near the top of a range with which we are comfortable in the present circumstances, given what we know - and equally importantly, don't know. Although the level of current and foreseeable fiscal and monetary stimulus should keep risk appetites supported, we do see some scope for volatility over shorter periods, with potential downside risks from geopolitical events, particularly as the US presidential election approaches, and, of course, the possibility of a resurgent Coronavirus. With this in mind, our "house view" tactical risk score was reduced from neutral to four / four and a half on a scale of ten at the very end of the period under review and our models' equity weightings trimmed back accordingly. The resulting proceeds provide a store of dry powder, with which we will seek to take advantage of any market drawdowns.

Bonds

In the core sovereign debt markets, there was minimal movement in Treasury or Bund yields across maturity curves over the quarter, with the respective ten-year benchmarks closing just one and two basis points (bps) lower, at 0.68% and -0.45%, and the corresponding Barclays Bloomberg >1 year Indices returning +0.48% and +0.17% for the period. The UK Gilt market, meanwhile, saw a decline of 18bps in the ten-year yield and a gain of +2.62% in its market index. Over and above the effect of the Bank of England's corporate bond buying as part of an asset purchase programme that is proportionately greater than both the Fed's or ECB's, additional demand by investors looking to replace income lost through cut or cancelled UK company dividends contributed to Gilts' outperformance of their US and German counterparts.

The strong returns recorded by corporate bonds were a function of the narrowing in yield spreads from multi-year highs that began in late March and continued, with the occasional pause, throughout the quarter. Broad US Dollar and Sterling investment grade (IG) benchmarks gained +9.27% and +9.07%, while the Euro equivalent was up +5.09%. It was a similar story in high yield, albeit with a weaker ending to the quarter that left the Barclays Bloomberg US HY Index (+10.18%) almost 3% below its intra-period high and the yield spread vs Treasuries 100bps above its corresponding low. Hard currency emerging market sovereign bonds, as measured by the JP Morgan EMB Index, also recorded a double-digit increase of +11.21%.

US BBB Yield vs Treasuries (basis points)



Source: Bloomberg

Assuming even the very best-case scenario of a vaccine discovery in short order and a swift V-shaped economic recovery, it is difficult to foresee a scenario in which interest rates do not remain at or around the current historic lows for some time. Indeed, given a more likely and less positive outlook, it's entirely possible that bond yields could go even lower. While the Federal Reserve (along with the Bank of England) has dismissed in the strongest terms any suggestion of using negative interest rates as a policy tool, the possibility of a shift to a strategy of yield curve control, à la Bank of Japan, as a more effective mechanism than the current QE programme is an idea that seems to be building momentum and credibility. Either way, our base case remains that bond yields remain subdued for the time being.

It is clearly no coincidence that the announcement of the Federal Reserve's intention to purchase IG corporate debt for the first time precisely marked the point at which markets bottomed out on March 23rd. As it turned out, merely the promise of such intervention was enough to turn sentiment around; the Fed's first purchases, of ETFs, did not take place until May 12th and individual bond issues were added to the programme only as recently as mid-June. Moreover, the volumes bought to date - around USD30 billion – have been relatively modest when compared with the total size of the facility (up to USD750 billion) and the record levels of supply in the new issues market. It is therefore probably safe to suggest that corporate bond markets will remain strongly supported for the foreseeable future and as a consequence we remain entirely comfortable with an approach to fixed income investing that, alongside a core of strategic managers, incorporates a bias towards credit. Nonetheless, we remain alert to any signs of deteriorating fundamentals – be they demand / supply dynamics, rising default rates, issue quality etc. - and are prepared to act accordingly.

Currencies

Having occupied a narrow trading range for the quarter's first eight weeks, the US Dollar succumbed to a sharp sell-off over the following fortnight which, measured by the DXY Spot Index, equated to a drop of almost 4% from peak to trough. A subsequent minor retracement left the Index 1.67% lower on a quarter-on-quarter basis.

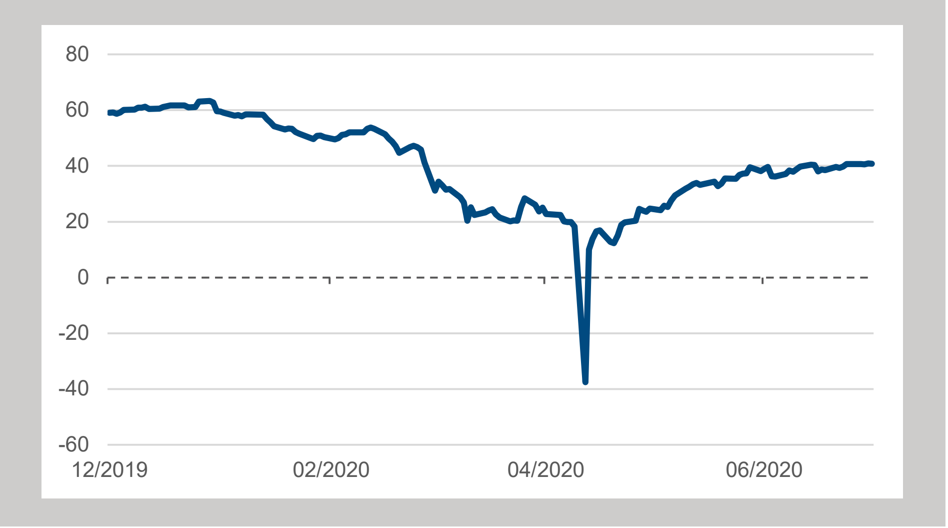
Among Bloomberg's list of 17 major currencies, only the Brazilian Real lost any meaningful ground in USD terms, declining by 4.79%, while the Pound Sterling and Japanese Yen were marginally weaker at -0.15% and -0.05% respectively. Developed economy currencies that had been among the prior quarter's weakest headed the list of gainers, with the Australian Dollar +12.91%, Norwegian Krone +8.77% and New Zealand Dollar +8.63%.

For emerging market currency bulls, of which we seem to be encountering a growing number, signs of an end to their multi-year bear market remain elusive. Although the JP Morgan EM Currency Index was up over the quarter, the fact that its 1.71% gain corresponded pretty much exactly with the above-mentioned Dollar Index's decline meant that gain was merely a function of Dollar weakness, rather than EMC strength. Based on the concept of mean reversion alone, the bull case for EM currencies is worthy of attention and becomes more interesting in a number of individual countries' cases when factors such as real interest rates and macroeconomic fundamentals are taken into account. As such, it is a potential opportunity that we have been watching closely for some time. Whilst we fully acknowledge the shortcomings of assessing emerging market assets (of all kinds) at anything other than a granular level, the fact remains that a sizeable chunk of the investment world does not work in that way. It is thus instructive to view them in the round for evidence of any shift in sentiment.

Commodities

Although the Good Book tells us that "*there is nothing new under the sun*" (*Ecclesiastes 1:9*), commodity markets witnessed the front month contract for West Texas Intermediate (WTI) trading at negative prices for the first time in its history. The precipitous decline in global oil demand resulting from widespread industry lock-downs combined with a severe (temporary) shortage of US storage capacity to create a unique scenario in which, for a brief period on the day of the aforementioned contract's April expiry, one could be paid $37.63 for taking delivery of a barrel of oil (or, more accurately, $37,630 for receiving 1,000 barrels). Though suffering from a similar downturn in demand, the absence of a storage bottleneck meant that the equivalent price for Brent crude was $33.33 bbl on the day in question, traded no lower than $27.05 at any point during the quarter and, as such, was a far more realistic measure of true value. Remarkably, given these dramatic events and the consternation that accompanied them, prices recovered strongly to record healthy q-o-q gains. Asia's emergence from lock-down, together with a new-found accord among producer nations on production cuts quickly shifted the market dynamic and the respective WTI and Brent ended the period up 96.34% and 20.92% from their opening marks at $40.21 bbl and $41.27 bbl.

WTI USD per barrel



Source: Bloomberg

Unsurprisingly, given that oil contracts account for 23% of its underlying weightings, the broad Thompson Reuters CRB Commodity Index charted a similar, if far less dramatic, course and also recovered from historic April lows to end the period up +13.29% in USD terms. Among other index components, Copper (+21.79%) stood out as an encouraging indicator of improving economic sentiment as did the modest gains in other base metals. Within the precious metals space, both Silver (+30.98%) and Gold (+13.71%) enjoyed healthy support. Whereas the former's increase represented little more than a bounce back from the previous period's fall, the advance in Gold extended its winning streak to seven consecutive calendar quarters and took the spot price per Troy ounce to within $117 / 6.19% of its September 2011 all-time high. With the favourable fundamental factors that we have discussed in previous commentaries supported by a particularly constructive technical picture, it is likely that the bullion exposure which has been a positive contributor to our models for the past two years will remain a core position for the time being.

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