Client Update – July 2020

We remain both realistic and optimistic about the future. We are now in a new "norm" and believe that, given time, investment values will recover from this crisis.

The Covid-19 crisis brought unprecedented volatility to financial markets. Stock prices collapsed over a five-week interval during February and March and then staged a sharp recovery through the second quarter. The chart below of the *MSCI World* index illustrates the scale of the movements, with a peak-to-trough fall of almost 34% but a net loss for the six month period of -6.7% % if invested in a Global Equity fund.

Federal Stimulus

While the decline was sparked of course by the economic impact of coronavirus, the recovery owed everything to **policy stimulus rather than any early improvement in the pandemic situation.** Applying the lessons of the Global Financial Crisis, authorities around the world were swift in deploying a range of fiscal and monetary support measures designed to bolster both household incomes and the functioning of capital markets. As ever, the Federal Reserve led the way. The scale of its intervention was reflected in the **63% expansion of its balance sheet** between mid-March and mid-June.

Market Resilience

Not surprisingly, within the overall resilience of the global equity universe there were wide disparities among sectors and countries. The big winners were the obvious beneficiaries in the technology and e-commerce arena, which extended the divergence between the 'Growth' and 'Value' styles which has been so marked in recent years. Add in the Federal Reserve stimulus there was a significant uplift in US values with the S&P 500 back to pre Covid values.

The so-called FANG index (dominated by Facebook, Amazon, Apple, Netflix and Google) rose to new highs post-crisis, gaining a net 32% year-to-date and building further on the considerable outperformance the group has already enjoyed throughout the past decade. Meanwhile consumer-facing companies in areas such as travel, leisure and entertainment suffered badly, with some high-profile bankruptcies in the retail sector. The energy sector was also a notable loser, thanks to the crisis-related collapse in crude oil prices.

Eurozone

Eurozone equities lagged the world index by a wide margin, losing a net 12.4%, which reflected the more unfavourable sector composition of European markets (less technology, more financials and 'old economy' companies). Emerging market equities were also a little behind the MSCI World, with a 9.8% decline. The loss would have been greater were it not for the robust performance of Chinese equities, reflecting an early recovery from the effects of the pandemic.

Government Bonds

Sovereign bond yields fell in tandem with the economic outlook, although they finished the period somewhat above the all-time lows reached in March. Euro inflation-linked bonds lost a little ground over the six months, down 1.6%. Their lag against nominal bonds reflected the decline in inflation expectations brought by the economic collapse, although arguably the risk of a longer-term resurgence of inflation is all the greater now given governments intervention and step-up in money printing around the world.

Corporate Bonds

Corporate bonds were caught up in the same volatile trends affecting equities. Credit spreads widened dramatically in the early weeks of the crisis, but then reversed much of that move as the Fed announced that it would backstop the market to ensure that debt finance remained readily available to companies.

Commodities

Commodities prices suffered badly during the period, as would be expected in a negative economic shock. Crude oil, which accounts for a large weighting in most commodity indices, fell almost 40%. Bizarrely, near-term oil futures contracts briefly traded at a negative price in April as producers were prepared to pay buyers to take oil off their hands due to the cost and lock of storage facilities.

Gold Update

One commodity which bucked the trend was gold, gaining 17% in euro terms. Gold typically performs well in periods of economic and financial stress, and it can serve as a useful hedging position alongside investment portfolios of mainstream asset classes.

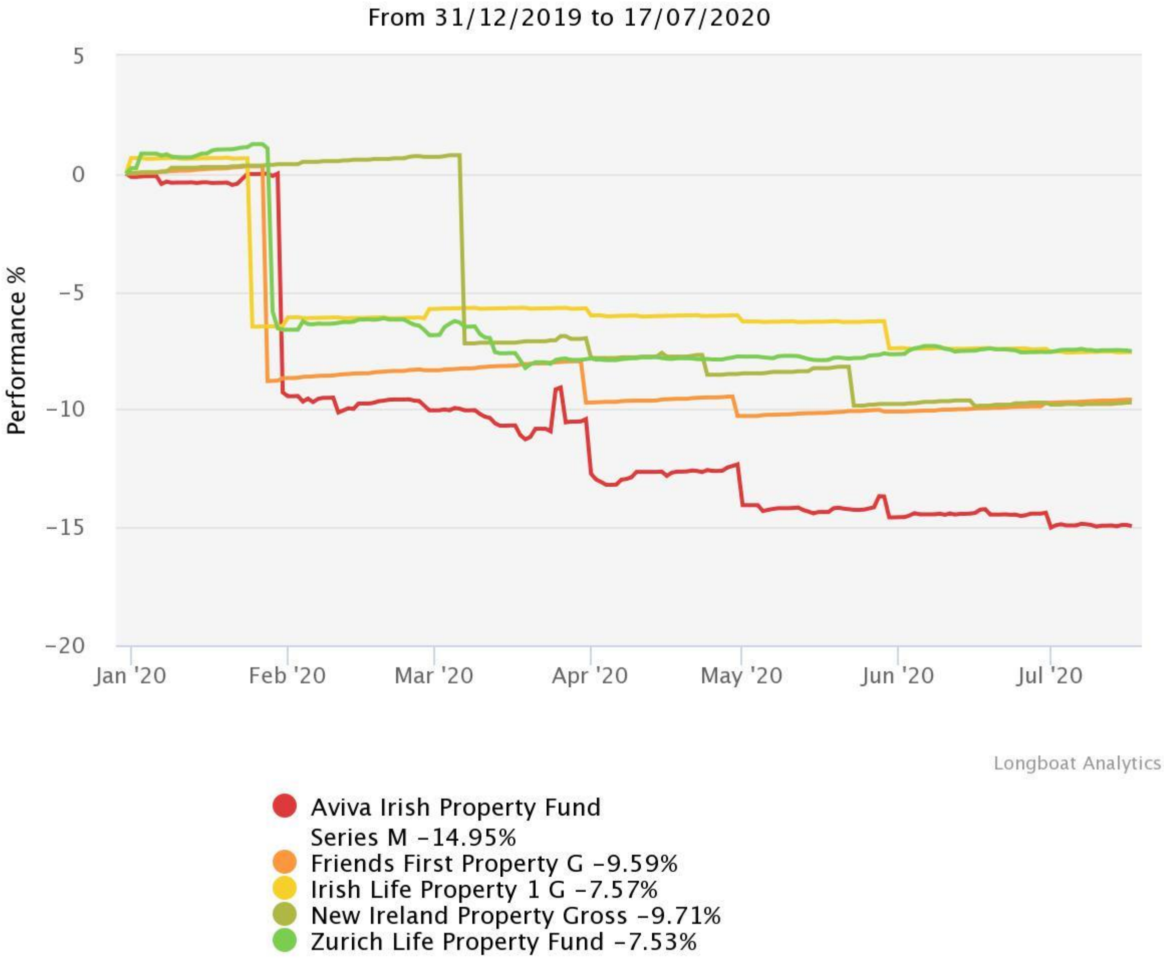
Gold broke through $1,800 in recent weeks with many predicting the ongoing uncertainty will push the commodity higher. The previous time it reached these levels was back in Sept 2011. For those investors who invested at that time in gold, it took a considerable dip in value subsequently and has taken a significant number of years to get back to par. While it may be viewed as a “safe haven” asset at the moment and has offered solid returns over the last 2 years there are risks that come with this also.

Commercial Property Outlook

The outlook for commercial property is likely to be very different and difficult in the wake of the Covid-19 crisis. Retail is the sector most obviously affected and lockdown has greatly accelerated the shift towards online shopping, a trend which was is now well under way.

Structural demand for office property may also suffer if remote working becomes a permanent feature for many enterprises, although social distancing needs might imply a greater space requirement per occupant. In the short term retail property values will be directly impacted by the scale of rent defaults suffered from Q2. This will filter through to values over the third and fourth quarter of 2020.

As it is the price movement year-to-date of direct property funds does not reflect the scale of damage their market has suffered. Property asset valuations are often slow to adjust to an abrupt change in market conditions. We would expect further property value declines through the remainder of 2020 and maybe further, even if economies and stock markets remain on a recovery path.



To illustrate the point, ***Hibernia REIT's*** share price finished the period at a discount of 38% to net asset value, with the discount having doubled from its level of 19% in December 2019. The main commercial property funds on the other hand are only down circa 12% yet contain similar assets. Our clients exit from Commercial Property in January was prescient, but nobody could honestly foresee what was coming down the tracks and the potential impact in the form of a Global Pandemic.

Outlook

As ever, our ability to predict future market movements is just as limited as every other commentator. The strong recovery clocked up by stock markets owes everything to ***official support from governments and central banks***, and very little as yet to any improvement in the fundamental picture. It looks like the disruptive effects of Covid-19 will be with us for an extended period and we still have to contend with the ***pending US presidential election*** and difficulties which may arise out of that depending on the current office holder accepting a clear result.

Some sectors will struggle to ever return to previous levels of profitability due to capacity reductions and permanent changes in consumer behaviour. Companies which have enjoyed the benefits of state support may find their ability to dispense cash to shareholders constrained. Current market valuations may not carry enough insulation against the bad news which lies ahead.

We are in an ever increasing time where it is difficult to preserve the value of savings with further reductions in deposit rates to near zero in recent months. For clients with a long-time horizon, ***equities are the only core asset class which still offers an appreciable return over cash***, albeit below what has been delivered in the past.

Equities offer both **liquidity** (access to funds when needed) and **inflation protection** for medium to long term investors.

Realistic and Optimistic about Recovery

As stated in our April update the current pandemic may still worsen further before improving. The US handling of the virus will fuel further market uncertainty (due to its size and impact on global markets) and has the potential for further market volatility once the true impact is felt.

However, we remain both realistic and optimistic about the future. We are now in a new norm and believe that, given time, investment values will recover from this crisis.

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Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up.

Warning: Forecasts are not a reliable indicator of future performance.

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