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Investment review - Q2 2020

30 June 2020

The second quarter of 2020 could not have been more different from the first. Global stockmarkets have recovered quite strongly since the lows seen towards the end of March, in some cases retracing nearly all their steps, which has helped to restore some respectability to calendar year returns. Even though there may still be some ground to make up, this year's extreme volatility has shown the importance of staying invested, if nerves allow it, to benefit from the sharp rebounds that frequently follow sudden downturns.

It might seem rather odd to have had such a powerful recovery in markets during the past quarter, particularly with the human and economic cost of the coronavirus crisis being so grim and cloaked in uncertainty. The relaxation of lockdowns in recent weeks has been encouraging, but many are only just starting to have some effect and we still have a long way to go to return to 'normality', whatever that looks like: large swathes of the global economy, particularly in the hospitality, leisure and travel sectors, as well a vast percentage of the global population, remain in various states of lockdown or continue to have restrictive measures placed upon them.

There is still of course the risk that relaxations may have been premature. The improvement in financial market sentiment, however, can be explained not only by the combination of the expected rebound in corporate profitability, but also by the further extensive stimulus and support packages doled out by governments and central banks: interest rates are now at or close to zero in many areas, quantitative easing has either resumed or been extended and there are deep commitments from monetary authorities to do even more if necessary. All these collective measures have pumped huge amounts of liquidity into the financial system, lowered borrowing costs for business and restored confidence. In turn it has coaxed investors out of cash into the relative attraction of a wide range of risk assets offering a real return, no matter how miniscule those returns are.

Encouraging signs

Given what we have been through in the past few months, it is no surprise to see recessionary conditions appear almost everywhere. Forecasts suggest that we could see global GDP sink by around 5% this year. This estimate is in stark contrast to a global increase nudging 3% in 2019. But it is at least encouraging to see leading economic indicators such as Purchasing Managers Indices ('PMIs') for both the manufacturing and services sectors already turning more positive and, in some countries, returning close to the critical 50 level, the symbolic divide between contraction and expansion. Most readings are, however, generally still some way short of pre-COVID levels.

Although global economic activity is still broadly in a contraction phase, momentum is now heading in a more positive direction almost everywhere, a clear indication that many economies are now re-opening and showing good signs of life after the relaxation of lockdowns. But the re-opening of economies is clearly still at quite a critical juncture, with the virus dictating the shape, pace and durability of the economic recovery. Undoubtedly there will be longer-term impacts of the lengthy lockdowns, as seen in the forecasts for areas like the UK and eurozone, preventing firms from returning to full capacity and causing consumers also to be more reluctant about their spending habits. It is therefore likely that global demand weakness will continue well beyond the lifting of lockdowns, with some sectors (and indeed economies) seeing more permanent impairment.

Quite what shape the recovery ultimately will take is still very unclear, but the mood and focus has definitely shifted in a more positive direction in recent weeks, as has the general confidence in financial markets.

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All of this is good to witness, and whilst stockmarkets may appear to have run a little ahead of the data, we should remember that they always do look more into the distance and as noted are additionally being boosted in the near term by the quantum of stimulus and lack of return from cash.

Regional variation

Drilling down into some regional economic growth forecasts, it seems as though particularly sharp declines will be seen this year in the UK and eurozone – these have not only been hit hard by the coronavirus, but recessionary conditions have been exacerbated by the timings and extent of lockdown measures. Furthermore, neither of these regions were in a particularly healthy economic state going into the crisis, so it is not surprising they appear to have come off worse. At the other end of the spectrum, China may actually deliver positive economic growth in 2020.

Looking further ahead, though, the growth expectations for next year look much more promising, assuming economies will have re-opened as far as practicably possible. But overall, forecasts suggest that it will not be until the end of 2022 that growth rates ‘normalise’ to pre-COVID type levels. Even then there are likely be some significant regional variations, with some economies likely to experience a permanent loss of activity relative to other regions as a result of the virus. Looking at this longer-term picture it seems that advanced economies are likely to be propped up by the superior economic performance of the USA and restrained by sub-par growth in the UK, eurozone and Japan. But overall, it is the economic performance of emerging economies, most notably emerging Asia, that stands out and is expected to be significantly stronger than advanced economies: not only are several Asian economies expected to come through the crisis in better shape and see less severe recessionary conditions this year, but their recoveries in 2021 and 2022 are expected to be stronger too.

Caution still required

These forecasts do, of course, assume that there will not be a significant second wave of the virus that places economies into lockdown again. The latest figures show that the total number of coronavirus cases has now risen to around ten million and cumulative deaths are approaching half a million globally. Worryingly, the number of new daily virus cases has seen a sharp increase over the course of the past few weeks, with the Americas being in the spotlight. Current expectations suggest a second wave would be less impactful than the first as we now know more about the virus, including how to treat it, how best to implement containment measures, and their impact on different parts of the economy.

Clearly, however, the quicker we can tackle this crisis through a combination of therapeutics, vaccines, diagnostics and enhanced public health arrangements, the quicker the global economy will recover. The good news is that as of late June there were nearly 200 COVID-19 vaccine developments in the global pipeline – only a small handful have so far reached the stage of clinical trials, but the race is most definitely on to find a solution that will allow us to live, learn and work safely again, as well as have the pre-virus freedoms of travel and socialising. Until an effective vaccine is found, the threat of more lives being lost and the return of lockdowns will continue to act as some restraint on economic activity and give an ongoing cautionary undertone to financial markets.

Market sentiment is therefore likely to wax and wane in the second half of the year, depending on the ongoing recoveries or relapses in both the coronavirus and economic activity in different parts of the world. On top of this we have the not insignificant matters of November’s US Presidential election and extraordinarily tight deadlines on negotiating a Brexit trade deal to look forward to. We also have the patching up or re-working of global trade relationships.

Many of the latter appear to have become more fractious as a result of the pandemic, which has accentuated some of the tensions between the US, China and Europe and may accelerate some decoupling of the global economy – for example, the more barriers that are placed in front of China and the more hostile international relations become, the more determined it will be to go it alone.

Redistribution of stockmarket exposure

For the time being we believe it remains appropriate to maintain our neutral stance on stockmarket commitments: we currently wish to balance further pandemic recovery potential and significant stimulus being bestowed upon risk assets with what we think is some sensible caution due to the nascent state of the world's emergence from the crisis, as well as other potential headwinds already noted. Under the bonnet, however, we do think it is appropriate to redistribute some of the stockmarket exposure to reflect some of the risks, trends and opportunities that have been accentuated and advanced by this year's events.

For sterling-based portfolios we have already made a meaningful shift in asset allocation in recent years towards overseas markets. But the pandemic has reinforced our conviction that more of tomorrow's success stories and higher levels of economic growth are more likely to be found much further afield than in the UK, or indeed in several of its close European neighbours. The UK stockmarket still trades at a discount to many of its developed market peers, and on the surface may therefore appear quite appealing from that valuation perspective. But there is growing evidence, perhaps accentuated by the pandemic, that suggests the UK may struggle to close the gap. Certainly, the disparity can be explained in part by the continuing Brexit uncertainty and sectoral biases towards poorly performing areas like energy and banking in terms of market composition. But a deeper influence appears to be a broad squeeze on profit margins relative to other regions: raised input prices emanating from sterling's weakness together with higher wage settlements have increased costs for many domestic businesses; UK corporate revenues on the other hand, which are perhaps more closely aligned with the global trade cycle than meets the eye, have also come under relative pressure.

On top of this, the plethora of UK companies coming with their cap in hand to raise more equity during the pandemic suggests that many were either being too generous to shareholders via their dividend policies or were being less prudently managed, with weaker balance sheets, relative to their international peers. Taking all these things into consideration, and leaving aside the influence of over- and under-represented sectors like energy and technology respectively, it seems the gap in the UK stockmarket's relative valuation and performance is not only justified but could also have some permanence. Even in these early days of analysing the longer-term consequences of the pandemic, economies and stockmarkets further afield in Asia and the US are already standing out as having differentiating growth drivers and hosting more of the companies that are likely to be at the cutting edge of taking the world forward in the 'new normal'.

In the immediate future, therefore, we will be reducing the commitment to the UK stockmarket and introducing a greater exposure to Asia outside of Japan. The attractions are varied: Asian economies not only came into this crisis in good shape, but they have not needed the same level of financial assistance from central banks and are therefore unlikely to be plagued by the longer-term headwinds of indebtedness faced by more developed economies. Being a net oil importing region, many economies should also see an economic boost from the collapse of the oil price. Companies generally have a greater appreciation for cash, stronger balance sheets and higher returns on invested capital than many of their western counterparts, so are in a much stronger position to withstand the current crisis – higher levels of cash retention and lower levels of debt also make the region a more appealing area for those income-seeking investors facing big dividend cuts elsewhere.

Asia also hosts some of the world's leading technology and healthcare companies, which are only likely to increase in demand as priorities and working practices change.

Many Asian economies had already been beneficiaries of the switch made by global businesses to alternative manufacturing hubs whilst the US/China trade war was in full swing, and this trend is only likely to continue if China continues to flex its muscles and further antagonises its international peers. Last, but by no means least, we should not ignore the strong tailwind of structural growth within the region from the domestic demand being created by Asia's emerging middle class. This is not an exhaustive list of positives, but in summary some of Asia's long-term attractions have been brought into closer focus by recent events – as home to more than half the world's population and accounting for an increasing percentage of the world's GDP growth, we think it deserves a more meaningful representation in portfolios.

This is unlikely to be our last move as we tip the scales even more towards those economies, sectors and companies that are likely to be at the forefront of change and participating in the longer-term drivers of global growth. This increased allocation to international markets may introduce some additional currency risks and may also involve paying a premium for quality growth investments, but this should be offset by the increased rewards that are brought from being allocated to those areas that are embracing change more rapidly than those that are being consumed by it.

Looking ahead

The coronavirus has cemented opinions on a wide number of things, but one of the strongest is the view that interest rates will be anchored at ultra-low levels for an extended period and inflation will undershoot central bank targets in the near term. A range of risk assets are therefore likely to remain supported and spurred on by continued stimulus – lower (or even negative) risk-free rates and low inflation have the propensity to drive up the present value of future profits and therefore we should not be surprised, or indeed too concerned, if markets do drift into higher valuation territory.

But markets rarely travel upwards uninterrupted for long periods and therefore any wobble may provide us with the opportunity we have been waiting for to take stockmarket allocations out of neutral, with the upward gear shift allowing us to reduce current cash levels and potentially tilt the scales further away from the UK and other struggling areas. Despite quite a rich valuation, the US stockmarket still boasts a vast number of progressive companies and sectors that are only likely to increase their dominance and share of the world pie going forward, so this is an area we still have in our sights for any increased allocation to equities. But it is important to stress that we are not about to abandon current more fragile economic areas like the UK, Europe and Japan altogether, as they still host many domestic and global businesses that are leaders in their respective fields.

We expect the active managers of the underlying funds we utilise to play a crucial role in unearthing those businesses that can still retain their competitive edge in an altered landscape. But clients can expect our general direction of travel towards an even more diversified international asset allocation to continue over the coming months and years. This shift is reflective of the forced advancements stemming from the pandemic itself and existing drivers of growth that have been given a large nudge forward by recent events.

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